BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

COMPLETED

New Mortgages For Financing Homes Need Uniform And Comprehensive Consumer Safeguards

Federal financial regulatory agencies have authorized new mortgage instruments for single family homes which have inconsistent consumer safeguards. Consumers are not assured of receiving adequate information for making decisions in selecting the mortgage which best meets their needs. Also, mortgage lenders are deprived of funds because they are unable to sell such mortgages to investors that purchase mortgages.

GAO believes a need exists for closer cooperation among regulators to develop and administer uniform safeguards for the various alternative mortgages. Regulators should offer the choice of a standard mortgage, provide adequate disclosure information to the home buyer on monthly payments and estimated total costs of the mortgage, study the interest rate adjustment provisions, and determine whether regulations should be revised to allow consumers more options in selecting the best mortgage maturity date terms for their needs.

CED-81-53
JULY 2, 1981

126

Request for copies of GAO reports should be sent to:

U.S. General Accounting Office
Document Handling and Information
Services Facility
P.O. Box 6015
Gaithersburg, Md. 20760

Telephone (202) 275-6241

The first five copies of individual reports are free of charge. Additional copies of bound audit reports are $3.25 each. Additional copies of unbound report (i.e., letter reports) and most other publications are $1.00 each. There will be a 25% discount on all orders for 100 or more copies mailed to a single address. Sales orders must be prepaid on a cash, check, or money order basis. Check should be made out to the "Superintendent of Documents".

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-203368

To the President of the Senate and the
Speaker of the House of Representatives

This report discusses several of the new mortgage instruments for single-family homes and their impact on home buyers and lenders. This review was made because many Americans purchasing homes in the future will be faced with selecting one of the new alternative mortgage instruments instead of the standard level payment mortgage which has been in use for about 40 years.

The report contains recommendations to the Department of Housing and Urban Development, the Federal Home Loan Bank Board, and the Comptroller of the Currency.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary, Department of Housing and Urban Development; the Chairman, Federal Home Loan Bank Board; and the Comptroller of the Currency.

Milton J. Socolar

Acting Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

NEW MORTGAGES FOR FINANCING HOMES NEED UNIFORM AND COMPREHENSIVE CONSUMER SAFEGUARDS

D I G E S T

For the past 40 years, Americans have relied almost exclusively on the standard level payment mortgage instrument as the sole means of financing single-family homes. Today mortgages used to finance homes are changing. Alternative mortgages are being introduced which permit monthly payments to fluctuate up or down, or start low and increase in later years. Consumers are not assured of receiving adequate information for making decisions in selecting the mortgage which best meets their needs. Also, mortgage lenders are deprived of funds because they are unable to sell such mortgages to investors that purchase mortgages. The principal types of alternatives to the standard mortgage are:

--Adjustable rate mortgages on which interest rates vary with changes in one of the money market interest rates.

--Graduated payment mortgages wherein the initial monthly payments are less than those under the standard mortgage but rise to higher than standard levels in later years. (See pp. 53 to 56.)

--Variable rate mortgages which permit the interest rate to vary both up and down according to some money market interest rate. Changing interest rates can be accommodated with changes in the monthly payment, the maturity of the loan, or a combination of the two.

--Renegotiated-rate mortgages which permit a loan to be issued for a term of 3, 4, or 5 years, secured by a long-term mortgage of up to 30 years, and automatically renewable at equal intervals. At renewal, no change other than in the interest rate may be made in the terms or conditions of the initial loan.

Tear Sheet. Upon removal, the report cover date should be noted hereon.

--Adjustable rate mortgage loans which permit a flexible loan instrument to be issued. The loan may be shortened or lengthened, but not more than a total of 40 years. Its interest rate may be adjusted by the lender from time to time and result in increases or decreases in monthly payments. There are no limits on the amount by which the interest rate may be adjusted either at any one time or over the life of the loan, or on the frequency with which it may be adjusted. (See pp. 16 to 20.)

The proponents of the new mortgages cite a number of reasons to change the standard mortgage. The high variability in inflation and interest rates, and the high cost of homes have placed increased pressure on mortgage lenders and home buyers. Consequently, many Americans have been priced out of the housing market, and lenders have been caught in a squeeze between the high cost of borrowing new funds and the relatively low revenues earned on existing long-term mortgage obligations. (See p. 1.)

The Federal agencies primarily responsible for regulating Federal alternative mortgages are the Department of Housing and Urban Development (HUD), the Federal Home Loan Bank Board, and the Office of the Comptroller of the Currency. These agencies are responsible for authorizing the various mortgages and developing a mechanism which insures that borrowers are provided adequate consumer safeguards. (See p. 1.)

UNIFORM CONSUMER SAFEGUARDS FOR ADJUSTABLE RATE MORTGAGES NEEDED

In designing adjustable rate mortgages two consumer safeguards have been controversial from the start: (1) borrowers should be provided a choice between a standard mortgage and the alternative mortgage being offered and (2) borrowers should be provided disclosure information to enable them to see what type of monthly payment obligations, including total costs, they are asked to take on, as compared to a standard mortgage.

In the past both the Congress and consumer groups have expressed concern that borrowers need to be provided a choice of the standard fixed-payment mortgage with sufficient information so they can properly analyze the new type of alternative mortgages. As a result, provisions for a choice of a standard mortgage and full disclosure emerged to help borrowers as part of the first adjustable rate mortgage authorized. (See pp. 22 to 26.)

However, more recent adjustable rate mortgage regulations provide consumers neither the choice of a standard mortgage nor full disclosure information on total costs of the alternative mortgages being offered. As a result, consumers may not have the ability or the financial information needed to shop around for the type of mortgage with the best price and terms which meet their particular needs. GAO believes that without such information, home buyers may enter into contracts which ultimately could exceed their ability to pay the increasing monthly mortgage payments, or take a disproportionate amount of their income to make such payments. (See p. 14.)

Federal Home Loan Bank Board regulations authorizing adjustable rate mortgages do not provide home buyers with consistent safeguards or needed information. For example:

--Home buyers are offered a choice of a standard mortgage under the variable rate mortgage regulations, but not under either the more recent renegotiated-rate mortgage or the adjustable rate mortgage loan regulations.

--Home buyers are presented information on maximum monthly mortgage payment changes under the variable rate mortgage regulations, but not under either the renegotiated-rate mortgage or the adjustable rate mortgage loan regulations.

--The maximum possible increase in interest rates is 2.5 percent under the variable rate mortgage regulations and 5 percent under the renegotiated-rate mortgage regulations. Thus, a mortgage with an interest rate of 10 percent could increase to 12.5 and 15 percent, respectively. There are no limits on the amount of increase under the adjustable rate mortgage loan.

--The maximum decrease in interest rates is 5 percent under the renegotiated-rate mortgage regulations, but there is no limit on the decrease under the variable rate mortgage regulations or the adjustable rate mortgage loan. (See pp. 14 to 20.)

The Office of the Comptroller of the Currency's new adjustable rate mortgage regulation provides that interest rate adjustments must occur at regular intervals and the maximum increase or decrease in the interest rate may not exceed 1 percent for every 6-month period between rate adjustments. The adjustable rate mortgage loan instrument authorized by the Federal Home Loan Bank Board does not contain this consumer safeguard. (See pp. 20 to 22.)

In addition to choice and disclosure safeguards, home buyers also need more options in selecting the mortgage note maturity date which can best help them manage the risk of future interest rate changes they assume under certain adjustable rate mortgages. (See p. 40.)

GAO recognizes that mortgage instruments are complex and that simplifying the safeguard requirements is no easy task. However, Federal agencies have a responsibility to insure that home buyers have the safeguards needed to make informed decisions when selecting adjustable rate mortgages.

HUD'S GRADUATED PAYMENT MORTGAGE COULD BE IMPROVED

GAO's analysis of HUD's graduated payment mortgage program disclosed that

--about 190,878 mortgages had been insured amounting to $8.9 billion (see p. 3);

--although mortgage payments will increase during the mortgage's early years, most HUD underwriters are not routinely assessing the home buyer's ability to meet increasing payments (see p. 56);

--HUD's refusal to include all graduated payment mortgage plans under the mortgage-backed securities program (bond-type investment securities representing an undivided interest in a pool of mortgages or trust deeds) has impeded the graduated payment mortgage program's growth because mortgage lenders are reluctant to initiate those mortgage loan plans which cannot be placed in a pool of mortgages on which securities are issued (see p. 59); and

--many home buyers are not being fully apprised of all graduated payment mortgage plans available, thereby losing the opportunity to tailor their mortgage payments to present and anticipated income. (See p. 61).

GAO found the home buyers participating in the graduated payment mortgage program were similar economically to home buyers who obtained mortgages under HUD's regular level payment mortgage insurance program. However, graduated payment home buyers purchased more expensive homes, made larger downpayments, and had larger mortgages than home buyers in the level payment program. (See p. 63.)

Also, HUD officials have raised serious questions regarding the financial soundness of the recently authorized section 245(b)

program, which broadens the availability of graduated payment mortgages to low- and moderate-income families. (See p. 75.)

RECOMMENDATIONS

The Chairman of the Federal Home Loan Bank Board and the Comptroller of the Currency should work together to develop uniform consumer safeguards for the various adjustable rate mortgages they have authorized or plan to authorize.

The agencies should:

--Require that home buyers under all adjustable rate programs be provided a choice between a standard mortgage and the adjustable rate mortgage being offered.

--Provide prospective borrowers full disclosure concerning monthly mortgage payment increases and total mortgage payments they potentially face over the life of their mortgage commitment.

--Study the interest rate cap structures for the various instruments being offered and applicable risks with a view toward establishing standardized interest rate caps that provide mutual and equitable protection to both consumers and lenders. (See p. 51.)

The Chairman of the Federal Home Loan Bank Board should:

--Determine whether borrowers should be given the option of different note maturity dates than now offered.

To improve HUD's graduated payment mortgage program, the Secretary should:

--Provide HUD underwriters with criteria to assess future income of home buyers applying for graduated payment mortgages.

--Require that the Government National Mortgage Association work with securities dealers, investors, and issuers to assure participation of graduated payment mortgage 10-year plans in the mortgage-backed securities program.

--Assure that home buyers are apprised of all payment plan options available under the graduated payment mortgage program. One method of doing this would be a certification signed by the home buyer that he or she was informed of all options available. (See p. 81.)

AGENCY COMMENTS AND GAO EVALUATION

The Federal Home Loan Bank Board disagreed generally with GAO's recommendations. It pointed out that the viability of savings and loan institutions has been severely hurt by an inflationary environment characterized by volatile interest rates and by deregulation of interest rates on savings. The Board argued that the lender's ability to make mortgage financing available through the use of adjustable rate mortgage authority would be restricted if the consumer safeguards GAO recommended were adopted. (See p. 46.)

GAO recognizes that thrift institutions face uncertainties in lending long and borrowing short in periods of volatile interest rates, and that many institutions are experiencing poor earnings and, in some cases, losses because of it. GAO also recognizes that the adjustable rate mortgage is one of the more promising ways to ameliorate this condition.

However, GAO also believes that flexibility offered to lenders by adjustable rate mortgages must be balanced by safeguards and the needs of consumers. Greater flexibility for adjustable rate mortgages may result if lenders are not required to offer buyers a fixed rate loan, provide worst case disclosure information, or evaluate the interest rate cap structures and the options buyers may have on the note maturity dates, but GAO questions

whether home buyers without these safeguards will be able to make informed decisions about adjustable rate mortgages. (See p. 46.)

Regarding GAO's recommendation that the borrower be given a choice between a standard mortgage and the adjustable rate mortgage being offered, GAO believes that options are available to protect lenders from the risk of financial losses stemming from future deposit interest rate increases during inflationary and tight money periods, namely (1) selling mortgages on the secondary mortgage market which will eliminate the threat of future financial losses by holding mortgages in their portfolios and (2) charging the borrower a premium for the standard mortgage. (See pp. 26 to 29.)

The Comptroller of the Currency stated that it would be premature to comment on the report because they had not yet finalized work on regulations authorizing new mortgage designs. However, the Comptroller said they would carefully weigh the issues raised in GAO's report as they proceeded to finalize the regulations. The regulations were issued on March 27, 1981. They do not provide for the action required by the two GAO recommendations applicable to regulations, namely (1) choice of a fixed rate mortgage and (2) worst case disclosure information for the home buyer.

Regarding GAO's recommendation that a study be made of the interest rate cap structure, the Comptroller's regulations have essentially eliminated caps by allowing that the maximum interest rate change may not exceed 1 percentage point for every 6-month period between adjustments.

HUD disagreed generally with GAO's recommendations to improve the graduated payment program. Regarding GAO's recommendation on the need for underwriting criteria to assess future income, HUD indicated that, while the need for underwriting criteria for the program has some merit in theory, it could not envision a set of criteria which would

not discriminate against some class of buyers on the basis of age or profession. HUD indicated that few employers would be willing to provide the type of assurance that would be necessary regarding a borrower's potential income. (See p. 79.)

GAO believes that HUD has not given adequate recognition to providing better assessments of home buyers' future income potential. For instance, under another insurance program, HUD requires verifiable statements from employers describing possible promotion opportunities for additional pay increases. Also, some HUD underwriters said they would probably deny loans to people on fixed incomes, while others said they had no objections in accepting that kind of income when approving loans. (See p. 79.)

HUD does not agree that all its graduated payment plans should be included in the mortgage-backed securities program. While the plans may pose technical problems, GAO believes that HUD should work with securities dealers, investors, and issuers to assure participation of the two graduated payment mortgage plans which permit monthly payments to increase over a 10-year period, in the mortgage backed-securities program.

Regarding GAO's recommendation that home buyers be apprised of all graduated payment plans, HUD indicated that it had made a concerted effort to promote the program and felt that it could not compel lenders to make a particular loan. GAO does not view its recommendation of apprising home buyers of all plans as a vehicle for forcing realtors, lenders, or home buyers to select a particular loan plan. GAO believes that HUD needs such information to assess whether or not all loan plans should be offered in the future. (See p. 79.)

Contents

		Page
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	Department of Housing and Urban Development	2
	Federal Home Loan Bank Board	3
	Office of the Comptroller of the Currency	4
	Major suppliers of mortgage credit	4
	Secondary mortgage market	5
2	THE CHANGING ENVIRONMENT IN MORTGAGE LENDING	7
	Evolution of the standard fixed payment mortgage	7
	What are AMIs and how will they affect financial institutions?	9
3	ADJUSTABLE RATE MORTGAGES NEED BETTER CONSUMER SAFEGUARDS	14
	Federal efforts to promote adjustable rate mortgage instruments	15
	Standardized safeguards and options needed for adjustable rate mortgage instruments	22
	Documented choice provision	22
	Federal adjustable rate mortgages need more comprehensive disclosure requirements	29
	Limitations on interest rate caps should be standardized after study	31
	Analysis of discretionary income	33
	Consumers should have a wider choice in selecting note maturity dates	40
	Recent AMI proposals by FHLBB	43
	Conclusions	45
	Agency comments and our evaluation	46
	Recommendations	51

CHAPTER		Page
4	IMPROVEMENTS NEEDED IN HUD's GRADUATED PAYMENT MORTGAGE PROGRAM	53
	Goals and objectives of section 245(a)	53
	Need to strengthen the underwriting criteria	56
	The secondary mortgage market problems with the GPM have impeded its growth and increased its cost	59
	Home buyers are not using all GPM plans	61
	Who is being served by section 245(a)?	63
	Potential problems with HUD's new section 245(b)	75
	Conclusions	78
	Agency comments and our evaluation	79
	Recommendations	81
5	OBJECTIVES, SCOPE, AND METHODOLOGY	83
	Methodology used to determine hypothetical four-person family income and consumption patterns for the period 1970 through 1990	84
APPENDIX		
I	Characteristics of Canada's rollover mortgage program	89
II	Information on special loans for the elderly; Wisconsin and California experience with AMIs; and creative financing techniques	92
III	Letter dated February 27, 1981, from the Chairman, Federal Home Loan Bank Board	99
IV	Letter dated February 13, 1981, from the Comptroller of the Currency	105
V	Letter dated March 12, 1981, from the Acting Deputy Assistant Secretary for Housing, Department of Housing and Urban Development	107

ABBREVIATIONS

AMIs	alternative mortgage instruments
AML	adjustable rate mortgage loan
ARM	adjustable rate mortgage
FHA	Federal Housing Administration
FHLBB	Federal Home Loan Bank Board
FHLMC	Federal Home Loan Mortgage Corporation
FNMA	Federal National Mortgage Association
GAO	General Accounting Office
GNMA	Government National Mortgage Association
GPM	graduated payment mortgage
HUD	Department of Housing and Urban Development
MBS	mortgage-backed securities
RRM	renegotiated-rate mortgage
OCC	Office of Comptroller of the Currency
SFPM	standard fixed payment mortgage
VRM	variable rate mortgage

CHAPTER 1

INTRODUCTION

Alternative mortgage instruments (AMIs) are posing new challenges to Americans purchasing homes. A homeowner is no longer assured a standard fixed payment mortgage (SFPM) with a fixed, level monthly mortgage payment. Instead, lenders are increasingly offering AMIs with monthly mortgage payments that could fluctuate up or down as with adjustable rate mortgages or start lower than a SFPM and increase over the mortgage's early years as with graduated payment mortgages.

The move to AMIs is attributed to the high rate of inflation, the increasing cost of homes, and the volatile movement in interest rates. The high cost of homes is pricing many Americans out of the housing market, while unexpected shifts in interest rates are making it more difficult for thrift institutions to balance the maturity of assets and liabilities, thereby putting increased pressure on their solvency. To cope with these problems, efforts were begun several years ago to develop new types of mortgage instruments that would provide homeowners a means of purchasing a home and at the same time offer lenders a better balance between their assets and liabilities. Presently, two types of AMIs are being used to deal with these problems, the graduated payment mortgage and the adjustable rate mortgage.

The principal Federal agencies that regulate mortgage credit have all authorized or are planning to authorize different types of AMIs. These agencies include the Department of Housing and Urban Development (HUD), the Federal Home Loan Bank Board (FHLBB), and the Office of the Comptroller of the Currency (OCC). AMIs are also being used by State-chartered thrift institutions in many States.

We selected only four of the myriad of mortgage instruments available for review; namely FHLBB's variable-rate and renegotiated-rate mortgages, OCC's adjustable rate mortgage, and HUD's graduated payment mortgage. These three agencies originate loans for the bulk of single-family homes in the Nation. After our review started, the FHLBB proposed two new types of mortgages, see page 44, the shared appreciation mortgage which requires the borrower to share the property's appreciation with the lender in return for an interest rate below that on a standard mortgage and the graduated payment adjustable mortgage which combines the adjustable interest rate feature of the renegotiated-rate mortgage with the graduated payment mortgage.

State-chartered savings and loan associations and mutual savings banks have been issuing various types of mortgage instruments for many years. Although our report discusses the major Federal programs offering new types of mortgage instruments, the high inflation, high interest rates, and the declining housing sales have caused private institutions and government agencies to develop diverse ways of financing housing sales. Some of these efforts involve (1) developing special types of mortgage loans to assist the elderly and (2) creating special types of financing techniques which encourage buyers, sellers, real estate brokers, and lenders to find a way of buying and selling homes in the tight money market.

Two of these new types of mortgage instruments are the reverse annuity mortgage which helps senior citizens enjoy their accumulated home equity without having to sell their homes and the escalator clause mortgage which permits the interest rate to be adjusted based on the lenders' costs. In some instances, the new mortgage instruments permit the mortgagor to extend the mortgage term, usually from 30 to 40 years. This feature may be incorporated in the variable-rate mortgage instrument. Information on some of the new types of mortgage loans for the elderly, creative financing techniques, and efforts by Wisconsin and California to promote new types of mortgages are included in appendix II.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

The National Housing Act of 1934 (12 U.S.C. 1701 et seq.) established loan insurance programs under the Federal Housing Administration (FHA) primarily to increase home construction and reduce unemployment during the Depression. Later, the Congress greatly increased Federal housing activities by enacting the United States Housing Act of 1937 (42 U.S.C. 1437 et seq.) and the United States Housing Act of 1954 (12 U.S.C. 1715z), which created low-rent public housing and mortgage insurance programs for low-income families and those displaced by urban development. The HUD mortgage insurance programs included in our review are discussed below.

Basic home mortgage insurance program

The National Housing Act of 1934 authorized one-to-four unit family home mortgage insurance under section 203(b) (12 U.S.C. 1709) to encourage capital investment in the home mortgage market. Under the program, commercial lenders are insured against loss for up to 97 percent of the property value and for terms of up to 35 years. The loans may finance

homes in both urban and rural areas, including certain farm homes.

Graduated mortgage payment program

Under section 245(a) of the National Housing Act of 1934, (12 U.S.C. 1715z-10(a)), as added by section 308 of the Housing and Community Development Act of 1974 (Public Law 93-383), HUD insures graduated payment mortgages to facilitate early homeownership for families that expect their incomes to rise. Under section 245(b), (12 U.S.C. 1715z-10(b)), authorized under section 311 of the Housing and Community Development Amendments Act of 1979 (Public Law 96-153), home buyers can qualify with a smaller downpayment than required under section 245(a). As of September 1980, HUD had insured about 190,878 mortgages under section 245(a) totaling $8.9 billion.

FEDERAL HOME LOAN BANK BOARD

The Federal Home Loan Bank Act (12 U.S.C. 1421-1459) established the FHLBB to strengthen existing home financing institutions by smoothing out the supply of funds when deposits are falling. The FHLBB system makes long- and short-term loans to member savings and loan associations.

The FHLBB regulates all Federal savings and loan associations which presently number 1,190. It also examines Federal associations and all State-chartered institutions insured by the Federal Savings and Loan Insurance Corporation and noninsured member institutions of the FHLBB system.

Adjustable rate mortgage programs

FHLBB authorized all Federal savings and loan associations nationwide to make, purchase, and participate in variable rate mortgages (VRM) in July 1979. In April 1980 and April 1981, FHLBB authorized the renegotiated-rate mortgages (RRM) and the adjustable rate loan mortgages (AML), respectively, for all Federal savings and loan associations to use nationwide.

Under a VRM, the interest rate varies both up and down according to a reference index. Changing interest rates can be accommodated with changes in the monthly payment, the maturity of the loan, or a combination of the two. In an RRM, the interest rate also varies both up and down based on a reference index. The RRM is a loan secured by a long-term mortgage commitment of up to 30 years which is financed by a series of short-term mortgage notes issued for 3 to 5 years.

The VRM does not have similar short-term mortgage notes. Changes in the interest rates are reflected in the monthly payments.

OFFICE OF THE COMPTROLLER OF THE CURRENCY

OCC was created for the purpose of establishing and regulating a national banking system. The National Currency Act of 1863 (12 U.S.C. 1 et seq., 12 Stat. 665) provided the chartering and supervising functions. OCC regulates national commercial banks which presently number 4,448. Due to the nature of their liabilities, mainly demand, rather than time deposits, commercial banks have engaged more in short-term investments than in long-term investments such as mortgages. However, recent growth and expansion of time deposits in the form of savings and certificates of deposits, and activities relating to trusteeship of pension funds, have allowed banks to participate increasingly in mortgage investments.

Adjustable rate mortgage program

OCC authorized national banks to make adjustable rate mortgages (ARM) in March 1981. The ARM regulations have essentially eliminated the interest rate caps by allowing that the maximum interest rate change may not exceed 1 percentage point for every 6 month period between adjustments. The interest rate can vary up or down based on a referenced index.

MAJOR SUPPLIERS OF MORTGAGE CREDIT

The chart on page 5 shows the amount of mortgage debt held by the major types of lenders as of December 31, 1979. About 62 percent, or $531.4 billion, of the funds made available for single-family home mortgages have been provided by savings and loan associations regulated by FHLBB or national banks regulated by OCC.

Residential Mortgage Debt (one to four units)
Outstanding as of December 31, 1979

Type of lender		Portfolio amount (billions)
Savings and loan associations		$394.4
1,190 associations regulated by FHLBB	$220.5	
2,719 State-chartered associations	173.9	
Commercial banks		137.0
4,448 national banks regulated by OCC	78.6	
10,290 State-chartered banks	58.4	
Mutual savings banks		64.7
All regulated by States but insured by the Federal Deposit Insurance Corporation		
Life insurance companies		15.4
Federally supported agencies		157.3
Others		91.4
Total		$860.2

SECONDARY MORTGAGE MARKET

The secondary mortgage market provides liquidity to the mortgage market by enabling mortgage lenders to sell bonds, notes, or mortgage-backed securities and use the proceeds to buy mortgages. Basically, the secondary mortgage market is a resale market where mortgages are bought and sold. The Federal Government has also established several secondary mortgage market institutions to promote a steady flow of funds for mortgage financing. The following briefly describes those Federal institutions.

Federal Home Loan Mortgage Corporation

Public Law 91-351 (amended by Public Laws 93-383 and 93-495) established the Federal Home Loan Mortgage Corporation (FHLMC), under the direction of FHLBB, to insure sufficient funds for mortgage financing. Section 305(a) directs FHLMC to purchase conventional mortgages from associations belonging to the FHLBB system, banks which insure their deposits with a Federal agency, and certain large State banks. Since 1970, FHLMC has been working actively to develop a private secondary mortgage market where investors can meet to buy and sell mortgages.

Federal National Mortgage Association

The Housing Act of 1954 (12 U.S.C. 1716 et seq.) created the Federal National Mortgage Association (FNMA), which purchases federally insured mortgages, such as FHA and Veterans Administration loans and, more recently, conventional mortgages, in order to moderate the decline in housing production that occurs during periods of credit stringency. FNMA is a financial intermediary that obtains funds by selling bonds and notes and uses these funds to purchase mortgages for its own portfolio.

Government National Mortgage Association

The Housing and Urban Development Act of 1968 (12 U.S.C. 1717) created the Government National Mortgage Association (GNMA). GNMA purchases certain types of mortgages to fulfill its statutory objective to increase liquidity in the secondary mortgage market and attract new sources of financing for residential loans through its mortgage-backed securities program. GNMA's other statutory objectives include providing support for types of housing for which financing is not readily available, such as housing for low-income families and countering declines in mortgage lending and housing construction.

CHAPTER 2

THE CHANGING ENVIRONMENT IN MORTGAGE LENDING

The environment in which mortgage lending operates is changing from one in which the SFPM was the sole means of financing single-family homes to one in which AMIs will play an increasingly important role. The SFPM operated well in a relatively stable interest rate and inflationary environment. However, the SFPM's inadequacies when inflation rates are increasing and high and volatile interest rates prevail have resulted in AMIs being authorized for use by mortgage lenders.

EVOLUTION OF THE STANDARD FIXED PAYMENT MORTGAGE

The fully amortized SFPM has been the country's standard mortgage instrument since the Depression. Before the Depression, a variety of financing instruments were used, with loan terms usually short term (less than 5 years), interest payable semiannually, the principal due at the end of the term, and large downpayments.

Until the 1920s, individuals, not financial institutions, were the largest category of mortgage lenders in the United States. Later, the birth of various thrift institutions provided a change in mortgage lending, but only after the savings concept became more common.

Commercial banks entered the real estate market after the Civil War, when State-chartered commercial banks offered low-ratio farm mortgages. In 1913 the Federal Reserve authorized federally chartered banks to make mortgages on improved farms for a 5-year term with a 50-percent downpayment. This authorization was extended in 1916 to include 1-year loans on urban real estate.

Single-family urban area homes accounted for a larger percentage of mortgage originations during the 20th century's first decades. A typical loan called for no less than a 50-percent downpayment with a 3- to 5-year mortgage term. There were no provisions for loan amortization, and interest was generally payable semiannually. The majority of these mortgages were renewed upon maturity since few families had the money to retire the debt. The mortgage companies originating them charged from 1 to 3 percent of the loan amount as a fee, and upon renewal, an additional 1-percent fee would be charged.

All mortgage lenders participated in the 1920s real estate boom, with prices appreciating 25 to 50 percent per

year. Many lenders ignored underwriting standards, believing inflation would bail out bad loans. When the crash came, real estate values plunged to less than half the level of the year before. The individual borrower and income property mortgagor were often unable to meet quarterly or semiannual payments because of large-scale unemployment.

Financial institutions were faced with a severe liquidity problem--debts were not being paid and savings were being withdrawn. They were often forced to sell vast real estate and mortgage holdings under very unfavorable conditions. Even homeowners who managed to retain their jobs were in danger of losing their homes when their 5-year mortgages expired because there was no money available to refinance loans.

Between 1931 and 1935, foreclosures averaged 250,000 each year, many experienced by Midwest family farms. Hysteria began sweeping the farm belt and some of the larger cities, and in 1933 States began enacting mortgage moratoriums. Although not providing any actual solutions, they at least kept the lid on what was becoming a turbulent situation.

Concerned about growing unrest and realizing the drop in real estate values would continue to add to the entire economy's depression, the Federal Government created a number of institutions to stabilize the mortgage and residential real estate markets. In 1932, the Reconstruction Finance Corporation was created to provide funds to financial institutions, mostly commercial banks, to help with the liquidity crisis. Shortly afterwards, the FHLBB was created, establishing 11 regional banks to provide funds for member savings and loan associations and similar institutions engaged in home financing. FHLBB generated funds by selling bonds and notes on the open market and making the funds available to member associations at a nominal markup. Later, in 1933, the Home Owner's Loan Corporation was established to provide Government-backed bonds to mortgagees for home mortgages in default and some cash loans to mortgagors for payment for a 15-year period on the installment plan.

The Federal Government's most influential act was the creation of FHA in 1934. FHA furthered the concept of installment, or amortized, loans which are so common today. In addition, by bringing the Federal Government into the mortgage insurance business, FHA created a national mortgage market. The correspondent system between mortgage companies and insurance companies, which was already in existence to a limited extent, helped establish a national mortgage market by using FHA standards for homes and

borrowers to move funds from capital-rich areas to capital-poor areas of the Nation.

WHAT ARE AMIs AND HOW WILL THEY AFFECT FINANCIAL INSTITUTIONS?

AMIs vary from the fixed payment mortgage in that the interest rate and/or the monthly payments may change during the life of a loan rather than remaining constant. The interest rate may be periodically adjusted to reflect conditions in the money market and/or the periodic payments may be adjusted to conform to expected changes in a person's earning capacity.

The two basic types of AMIs are the graduated payment mortgage and the adjustable rate mortgage. Graduated payment mortgages reduce a homeowner's monthly payments in the mortgage's early years. By providing lower payments, the graduated payment mortgage enables home buyers, who would not otherwise qualify, to purchase a home or to purchase a larger home than they would initially qualify for with a SFPM.

Adjustable rate mortgages allow monthly mortgage payments to fluctuate up or down throughout the mortgage term in accordance with a reference index. The term adjustable rate mortgage is used in this report to describe several types of mortgage instruments more commonly called VRMs, RRMs, and rollover mortgages.

VRMs contain periodic interest adjustment dates when the lender may increase or decrease effective interest rates. The adjustment is determined on the basis of an index. For example, a lender might use the FHLBB national average cost-of-funds index for savings and loan associations insured by the Federal Savings and Loan Insurance Corporation.

RRMs have long-term mortgage commitments and loan amortization periods, usually up to 30 years. However, the mortgage contract note usually terminates within 5 years and must be renewed. The renewal is guaranteed, and upon renewal, the interest rate is subject to change based on regulations.

Rollover mortgages, on the other hand, have short-term mortgage commitments and mortgage note periods of generally the same length. The note is usually not guaranteed renewable, and the outstanding principal is payable in full at the end of the term. Each new agreement between a lender and borrower contains both a new mortgage commitment and a new mortgage

quoted interest rate or seeking mortgage financing elsewhere. This type of mortgage is the standard mortgage instrument now used in Canada. Americans that select an RRM have a 30-year mortgage commitment from the bank whereas in Canada the home buyers might have only a 5-year mortgage commitment.

Impact of AMIs on lenders

Only adjustable rate mortgages address the basic problems facing many lending institutions--matching asset and liability maturities. Many lenders are holding large inventories of older, low-interest rate mortgages yielding low revenues, while they now must pay higher interest rates on deposits and other liabilites. The adjustable rate mortgages will assist the lenders to better match mortgage asset and deposit liability maturities by increasing interest revenues. This reduces the risk to lenders that they will be damaged by future unexpected cost-of-fund increases. Some housing experts believe that with reduced risk, lenders in a competitive market might require less interest rate risk premium and be able to lower mortgage interest rates in the long run.

Lenders are faced with the uncertainty of financing long-term mortgages by using short-term deposits when they offer SFPMs. Interest rates in the economy have been generally increasing over the last 15 years. As interest rates rise, interest on deposits rise as well, while interest rates on existing SFPMs remain constant. The spread between borrowing rates and lending rates has narrowed. In fact, for several months in 1973 and 1979 the cost of funds for lending institutions was higher than the mortgage interest rates.

However, higher mortgage interest rates more in line with the higher cost of funds are available to lenders only on relatively new mortgages, which are often only a fraction of the total mortgage portfolio held by some lenders. This is a problem particularly in the Northeast, where lenders hold a higher proportion of older, low-interest bearing mortgages. Some housing experts have expressed concern about the survivability of many Northeast institutions.

Professor Craig Swan, in a study 1/ presented to the American Finance Association in September 1980, indicated that in a free market environment the problem need not be quite as bleak as it appears on the surface. First,

---

1/We did not evaluate the basis for the assumptions used in this study.

long-term interest rates should reflect expected possible future increases in short-term rates. Thus, if interest rates rise, high revenues in the early period of the mortgage, when lending rates exceed borrowing rates, can offset the high discounted losses or low revenues experienced during the later period of the mortgage.

However, continued uncertainty and unexpected upward movement in interest rates do cause serious problems. Mortgage lenders have certain disadvantages in competing for funds with other financial institutions. They are prevented by regulation from making investments in areas other than housing. Thus, they have limited portfolio flexibility. In addition, while interest paid on deposits must be competitive, revenues derived from mortgages may not reflect true market rates.

AMIs are aimed at helping solve the problem of mismatched mortgage asset and deposit liability maturities. In theory, whenever there is an unexpected increase or decrease in deposit interest rates, adjustable rate mortgages would permit increases or decreases in interest payments on that portion of the mortgage portfolio made up of the new instruments. Thus mortgage interest revenues would be more closely linked to the cost of funds.

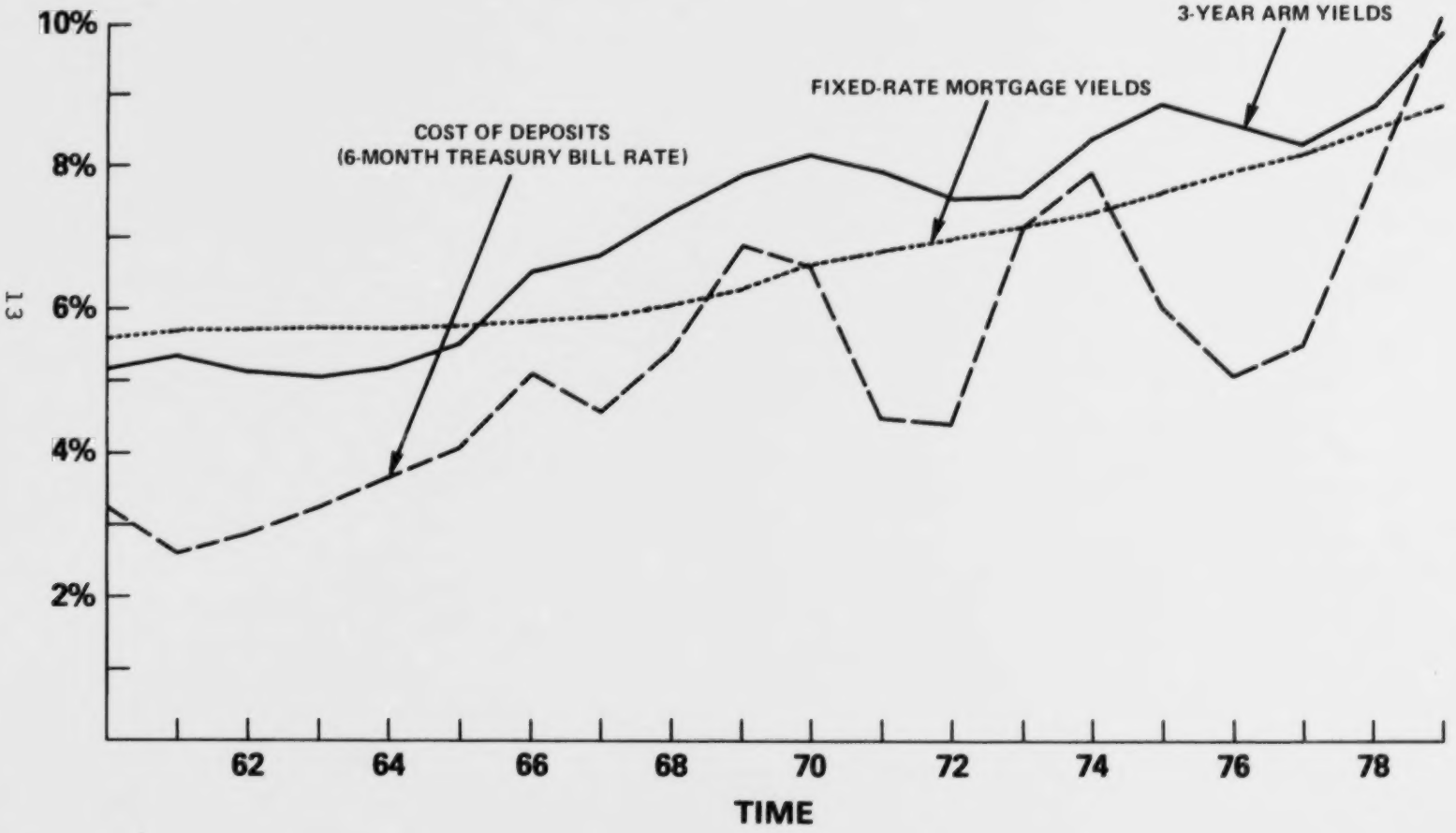
To evaluate and illustrate the impact of adjustable rate mortgages on lenders, Professor Swan simulated the costs and revenues of a 3-year ARM portfolio as compared to a SFPM portfolio. Professor Swan simulated a hypothetical portfolio using the aggregate lending volumes for savings and loan associations from 1953 to 1979. Actual interest rates on mortgages were used to simulate average portfolio yields for SFPMs. Interest rates for the ARM were calculated by using 3-year and 5-year Federal borrowing rates plus 1.5 to 1.6 percent. The 6-month Treasury bill rate was used to represent the cost of funds.

The results for the 3-year ARM and the SFPM are shown on page 13. While revenues fluctuate more for the 3-year ARM than the SFPM, they were always higher than the cost of funds. On the other hand, SFPM revenues fell below the cost of funds in several periods which indicates cash flow problems.

Professor Swan stated that while these simulations have limitations and do not fully capture all of the complex financial market forces, they suggest that adjustable rate mortgages can help address the basic problem of mismatched assets and liabilities. Professor Swan concluded that the

fewer limitations and restrictions on the adjustable rate mortgage, (i.e., the more flexible they are in adjusting to market forces) the better they will meet the needs of the lending institutions. However, he indicated that this flexibility must be balanced against the needs of and safeguards for the home buyer.

SIMULATED AVERAGE PORTFOLIO YIELD, AND COST OF DEPOSITS 3 YEAR ARM



CHAPTER 3

ADJUSTABLE RATE MORTGAGES

NEED BETTER CONSUMER SAFEGUARDS

FHLBB and OCC have authorized adjustable rate mortgage regulations which contain different consumer safeguards. As a result, some consumers obtaining mortgages from financial institutions regulated by these agencies will enjoy greater safeguards than others. For example, consumers would receive complete disclosure of maximum potential monthly mortgage payment increases under one program but not under other programs. A summary of the major differences in three Federal adjustable rate mortgage programs follows.

Key consumer safeguard provisions	FHLBB's VRM	FHLBB's RRM	FHLBB's AMI	OCC's ARM
Maximum limitations on interest rate increases	2.5%	5%	None	None
Maximum limitations on interest rate decreases	None	5%	None	None
Equivalent annual limitations on interest rate increases and decreases	0.5%	0.5%	None	2.0%
Consumer offered choice of standard fixed payment mortgage	Yes	No	No	No
Consumer shown maximum potential monthly mortgage payment amounts	Yes	No	No	No

Note: Interest rate increases or decreases are in absolute terms. For example, a 5-percent increase occurs when the interest rises from 10 to 15 percent

To insure reasonable and equitable safeguards for all consumers, uniform standards are needed for adjustable rate mortgage instruments.

In addition, without determining the effect on either consumers or lenders, FHLBB and OCC adopted annual and/or overall limitations, or "caps," on the amount that interest rates can increase or decrease over the life of a mortgage

commitment. The interest rate caps do not provide mutual and equitable protection to all consumers and lenders. The recent FHLBB AML regulation does not provide for either annual or overall limitations on interest rate increases.

Finally, while adjustable rate mortgage instruments place most of the risk of future interest rate increases on consumers, FHLBB's RRM does not provide consumers options with which to minimize risk. For example, consumers might have to take a 3-year RRM even though they believe interests rates may decline after signing the loan document. Canadian consumers, on the other hand, can usually select from a variety of Canadian rollover mortgage maturity dates which allows them to better manage their financial affairs. Details on the characteristics of Canada's rollover mortgage program are presented in appendix I.

FEDERAL EFFORTS TO PROMOTE ADJUSTABLE RATE MORTGAGE INSTRUMENTS

FHLBB authorized California federally chartered savings and loan associations to use VRMs in January 1979 and all Federal savings and loan associations nationwide in July 1979. This action was the third in a series of FHLBB efforts to have VRMs authorized for Federal associations. FHLBB's RRM and AML were authorized in April 1980 and April 1981, respectively. OCC's ARM was authorized in March 1981.

FHLBB's first two efforts to introduce VRMs were unsuccessful

FHLBB's first two efforts to authorize VRMs occurred in 1972 and 1975. On both occasions, FHLBB was forced to withdraw the proposed regulations in the face of intense congressional opposition. In 1975, the Senate adopted Senate Concurrent Resolution 45 to halt FHLBB's action.

The first two efforts were unsuccessful because VRMs were perceived as disadvantageous to consumers. Some believed VRMs would pit home buyers against lenders in a match to see who was better able to predict future interest rates, and on the average, consumers would lose that game. Although recognizing VRMs as a partial remedy for this country's chronic cyclical instability in the supply of mortgage credit, the Congress felt the price consumers had to pay was too high.

The January 1979 VRM regulations were authorized for use in California only despite some congressional, consumer, and labor opposition. At a December 14, 1978, meeting during which the VRM regulations were adopted, FHLBB's Chairman stated that they had worked with the Congress and consumer and industrial groups in developing the regulations. Also, the Chairman stated FHLBB had received clear indications from congressional committees that the VRM regulations were acceptable.

Characteristics of FHLBB's VRM program

FHLBB's May 1979 regulations authorized Federal associations nationwide to make, purchase, and participate in VRMs. The regulations stated the authority was necessary to offset higher interest costs on savings accounts, some of which were also variable.

FHLBB's VRM regulations allow lenders to adjust the interest rate up or down 0.5 percent a year. The maximum increase is 2.5 percent over the life of the loan with no downside limit. Downside adjustments are mandatory, but increases are at the lender's option. The smallest adjustment up or down is 0.1 percent.

Interest rate adjustments are made in accordance with movements in the average cost of funds to insured savings and loan associations for all FHLBB districts, as published in the Federal Home Loan Bank Board Journal. For example, if FHLBB's average cost-of-funds index increases from 9.5 percent to 10 percent in a year, the borrower's interest rate would be subject to a 0.5-percent interest rate adjustment. Adjustments may not be made more than once a year.

With a FHLBB VRM, each prospective borrower receives materials explaining the VRM offered and a comparable standard mortgage instrument. The materials include a side-by-side comparison of differing interest rates and other terms and payment schedules for both instruments including a "worst case" schedule for the VRM which shows potential monthly payments if interest rates increase to the maximum extent possible. Also, information on the index used, the borrower's options if interest rates increase, and a prominent statement that the borrower has an option to select a SFPM is also provided.

Borrowers also receive written notification of any interest rate adjustment at least 1 month before the new interest rate's effective date. If the adjustment is a rate increase, borrowers are informed that they have an option to

extend the loan maturity up to one-third of the original loan term or prepay the loan, in full or in part, without penalty within 90 days of the notification. If the adjustment is a rate decrease, the borrowers are given a description of the way the decrease will be applied.

FHLBB's VRM program has not been accepted by Federal associations

There has been little VRM activity by Federal associations to date. FHLBB has not monitored the program's implementation, but a headquarters official stated that based on his contacts with district banks, the VRM program's use has been minimal. Also, economists in FHLBB district banks told us there was little or no VRM activity in their areas.

A survey made by the San Francisco Federal Home Loan Bank showed that only 8 of the 73 California Federal associations responding were offering VRMs as of June 30, 1979. The survey also showed that only 1,521 of the total 26,526 loans closed during the period January 1, 1979, through June 30, 1979, were VRMs and that 90 percent of those were issued by only two associations.

Federal associations we contacted provided several reasons for the absence of VRM activity. They included the lack of a secondary market for VRMs, consumer resistance to the instrument, and restrictive interest rate caps which do not give them the flexibility to deal with the interest rate volatility experienced in the market place.

Because deposit inflows have not been able to meet the demand for loanable funds, lenders are obtaining funds through the secondary mortgage market. However, at the time of our review neither FNMA nor FHLMC had established secondary mortgage market programs for VRMs. Thus, some Federal association officials said they are not offering VRMs.

Another reason offered for minimal use of the VRM was that borrowers prefer the SFPM when given a choice between VRMs and SFPMs. Some Federal association officials believed that the VRM was a difficult product to market, especially with the requirement for the worst case schedule of VRM payments.

Some Federal association officials also said they were not offering VRMs because FHLBB's VRM does not go far enough to relieve the cost squeeze they were experiencing. They cited the 0.5-percent annual interest rate cap and the 2.5-percent overall cap as unrealistic and believe that interest

rate adjustments should more closely follow increases and decreases in their cost of funds.

Characteristics of FHLBB's RRM program

FHLBB authorized Federal associations to make, purchase, and participate in RRMs effective April 3, 1980. The introduction of this instrument was intended to relieve the severe stress on the thrift industry's earnings.

In a March 27, 1980, statement to the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, the FHLBB Chairman stated

> "S&Ls must be able to find ways to generate the income they need to pay an attractive and equitable return to savers and thus stay in business as mortgage lenders."

The Chairman also said RRMs were essential if savings and loan associations were to avoid a mortgage credit famine in the years to come.

A RRM is a loan secured by a long-term mortgage commitment of up to 30 years which is financed by a series of short-term mortgage notes issued for periods of 3, 4, or 5 years. The notes are automatically renewable at equal intervals. The loan must be repayable in equal monthly installments of principal and interest during the loan term, in an amount at least sufficient to amortize a loan with the same principal and at the same interest rate over the remaining mortgage term. At renewal, no change other than in the interest rate may be made in the initial loan contract.

Unlike the VRM which uses a cost-of-funds index, interest rate adjustments on the RRM reflect the movement of the most recent monthly "national average contract interest rate on the purchase of previously-occupied homes" as published in the Federal Home Loan Bank Board Journal. The maximum limitation on periodic interest rate increase or decrease is 0.5 percent per year multiplied by the number of years in the mortgage note term. For example, the interest rate on a 3-year RRM could not increase or decrease more than 1.5 percent during each note renewal period. The maximum increase or decrease over the life of the mortgage is 5 percent. Interest rate decreases from the previous mortgage note rates are mandatory. Interest rate increases are optional to the association, but the association may obligate itself to a third party (e.g., a secondary market purchase) to take the maximum increase permitted. The borrower may

not be charged any costs or fees in connection with the renewal of the mortgage note.

At least 90 days before renewal, the association must send written notification to the borrower. The notification will include information concerning the new mortgage note term, new interest rate, and new monthly payment. The association also informs the borrower that the entire loan or part of it may be paid without penalty.

An applicant for a RRM must be given a specific disclosure notice. The notice generally explains the difference between RRMs and SFPMs. It shows the index used, the loan term, the length of the underlying mortgage, interest rate caps, and the options of lenders and borrowers at the time of note renewal. However, RRM regulations do not require that consumers be offered a choice of a SFPM or shown the maximum possible increases in their monthly payments, as required under FHLBB's VRM regulations.

Characteristics of FHLBB's AML program

On April 23, 1981, FHLBB issued its AML regulation. The regulation provides that:

--Lenders can use any interest rate index that is readily verifiable by the borrower and is beyond the lender's control. Indexes that would be acceptable, include (1) the national average mortgage contract rate for major lenders on the purchase of previously occupied homes, as computed monthly by the FHLBB, (2) the average cost of funds to Federal Savings and Loan Insurance Corporation-insured savings and loan associations, either for all Federal Home Loan Bank districts or for a particular district or districts, as computed semi-annually by the FHLBB, (3) the monthly average of weekly auction rates on Treasury bills with a maturity of 3 or 6 months, as published by the Federal Reserve System, (4) the monthly average yield on Treasury securities adjusted to a constant maturity of 1, 2, 3, or 5 years, as published by the Federal Reserve System, and (5) any other interest rate index that meets requirements of the regulation--generally that the index is readily verifiable by the borrower and is beyond the association's control.

--A rate adjustment may be implemented through changes in the payment amount, the outstanding principal loan balance, and the term of the loan, provided that the term never exceeds 40 years.

--The borrower may not be charged any costs or fees in connection with regularly scheduled adjustments to the interest rate, the payment, the outstanding principal loan balance, or the loan term.

--At least 30 days, but not more than 45 days before adjustment of the monthly payment, the lenders must send written notice to the borrower containing information on (1) the fact that the payment is scheduled to be adjusted, (2) the outstanding balance of the loan on the adjustment date, (3) the interest rate on the loan as of the adjustment date, (4) the index value on which the rate is based, (5) the period of time the interest rate will be in effect, (6) the payment amount and, (7) date(s) on which the rate was adjusted since the last payment adjustment, the rates on each such rate adjustment date, and the net change in the outstanding principal loan balance since the last payment adjustment.

In addition, FHLBB's AML regulation places no limit on (1) the amount by which the interest rate may be adjusted either at any one time or over the life of the loan, or on the frequency with which it may be adjusted and (2) the amount of negative amortization that can occur on an AML.

Further, FHLBB's AML regulation established a disclosure format similar to that of the RRM and attempts to ensure that consumers are given the information to negotiate and choose the mortgage instrument most suitable to their needs. The borrower will be provided a textual explanation of the flexibility provided by the AML regulation, summary of the key terms of the type of AML to be offered the borrower, and a short explanation of each term. Also, the AML regulation requires the lender to provide an example of the operation of the type of AML to be offered the borrower.

The FHLBB's AML regulation provides for the termination of the VRM and RRM programs as of July 31, 1981. By rescinding the VRM regulation, the Board will delete the existing provisions that limit an association's VRM investments to 50 percent of the association's total home mortgage loans and will delete the requirements that Federal associations offer the choice of a SFPM to applicants who are eligible for a VRM, graduated payment mortgage, or reverse annuity mortgage.

Characteristics of OCC's ARM program

On March 23, 1981, in a news release the Comptroller of the Currency issued the final regulation governing adjustable

rate mortgage lending by national banks. In releasing the regulation, the Comptroller emphasized that the availability of adjustable rate mortgages is intended to encourage national bank participation in residential mortgage market and provide a flexible framework within which banks can design mortgages to meet the needs of their local markets and borrowers, while at the same time respond to changes in interest rates that affect their cost of funds.

OCC's ARM regulation provides that:

--Interest rate adjustments must correspond to changes in one of three national interest rate indexes (6-month and/or 3-year Treasury rates, and FHLBB long-term contract rates for previously occupied homes).

--Interest rate adjustments must occur at regular intervals not shorter than 6 months.

--The maximum increase or decrease in the interest rate may not exceed 1 percent for every 6-month period between rate adjustments. Changes greater than 1 percent may be carried over to the next period.

--Interest rate increases provided for by the index may be imposed at the bank's option, but decreases provided by the index are mandatory.

--Written notification of any rate adjustment must be provided 30 to 45 days before the rate change goes into effect.

Interest rate adjustments under OCC's regulations may be made by changing the payment amount and/or the rate of amortization, but the maximum amount of negative amortization may not exceed certain limits. For instance, during periods when the monthly payment is to remain fixed, negative amortization is limited to 1 percent of the principal outstanding at the beginning of the fixed-payment period times the number of 6-month intervals within the period. At no time can the amount of negative amortization exceed 10 percent of the principal outstanding at the beginning of the fixed-payment period. Negative amortization occurs when the payment amount is not sufficient to cover the amount of interest due that month, and the amount of principal is actually increased.

In addition, OCC's regulations provide that banks must disclose to prospective ARM customers information on the index used, how a payment schedule for a similar loan would be affected by changes in the index, as well as certain other

information. This information is provided no later than the time when the ARM loan application is given to the customer. Borrowers will be provided with examples of interest rate and payment changes over several years. The regulations do not impose limitations on the number of different examples or additional information that may be provided, and banks are encouraged to go beyond what is minimally acceptable in educating their borrowers, as long as this is not done in a misleading manner. OCC's regulation notes that worst-case disclosure is more likely to mislead borrowers than to help them.

STANDARDIZED SAFEGUARDS AND OPTIONS NEEDED FOR ADJUSTABLE RATE MORTGAGE INSTRUMENTS

Federal regulators need to develop standard consumer safeguards and options for adjustable rate mortgages. This would (1) insure similar treatment to all consumers obtaining adjustable rate mortgages from financial institutions regulated by the Federal agencies, (2) create a standard that could be used as a model by States authorizing adjustable rate mortgages, and (3) facilitate sales of adjustable rate mortgage packages on the secondary mortgage market.

In proposing their VRM regulations in 1978, FHLBB took the lead in developing standards to serve as a national model for consumer safeguards. In testimony on August 22, 1978, before the Senate Committee on Banking, Housing and Urban Affairs, a former FHLBB Chairman stated

> "* * *It is my conviction that Federal agencies should be leaders, not followers, in their concern for the rights of the consumer. Today, we have national banks, State chartered savings and loans, State chartered commercial banks, and mutual savings banks offering alternative mortgage instruments with no general rules of protection for the consumer. Only federally chartered savings and loans lack this authority. I think that the Bank Board has an obligation to establish sound consumer safeguards to serve as a national model."

Documented choice provision

While FHLBB's VRM borrowers are required to be given a choice of a SFPM and comparison of the SFPM to the VRM, FHLBB's RRM and AML regulations and OCC's ARM regulation do not require that a "documented choice" be made available to consumers. Documented choice means that consumers are given

a choice of mortgage instruments, including a SFPM, and that lenders must inform consumers of this choice and provide a side-by-side comparison of all mortgage contract terms for the SFPM and the adjustable rate mortgage.

Several factors suggest that Federal regulators should include the documented choice provision in all their adjustable rate mortgage regulations. They include

--strong support for the concept of choice when FHLBB's VRM was introduced and during congressional hearings on the proposed RRM regulations,

--a desire for the availability of SFPMs by consumers, and

--the existence of options to lenders which can reduce the risk of financial losses inherent in SFPMs.

Documented choice has received wide support

At the time the VRM was introduced, documented choice was a key factor recognized by the Congress in 1975 Senate hearings on the resolution, see page 15 of this report. Also this was acknowledged as an important consumer safeguard by consumer representatives, lenders, academicians, and FHLBB. Despite these concerns, FHLBB chose to exclude the documented choice provision from its RRM regulations. OCC also has no documented choice provision in its ARM regulation.

The 1977 Alternative Mortgage Instruments Research Study (published by FHLBB and prepared, in part, by academicians) points out that consumer choice ranks as one of the most important and controversial consumer issues. The report states that "* * *There is a fairly strong case for regulations or legislation to ensure that borrowers are given a fair and reasonable choice of the SFPM as an option."

During Senate hearings conducted before FHLBB authorized the VRM, consumers' need for choice was a central issue in the debates. In October 1977 an FHLBB official made the following statement before the Subcommittee on Financial Institutions, Senate Committee on Banking, Housing and Urban Affairs:

> "* * * 'Documented choice' appears to be the most important of the safeguards in terms of providing a means of insuring that borrowers (1) are made aware that a choice exists, (2) receive the appropriate

information so that the choice is understandable, much in the same way 'unit-price' information helps in grocery stores, and (3) have the ability to effectively 'shop around' for the type of mortgage with the price and non-price terms they seek."

In August 1978 hearings before the Senate Committee on Banking, Housing and Urban Affairs, the executive vice president of a large California Federal association stated on behalf of the National Savings and Loan League:

"* * *we strongly support the principle that consumers should have a documented freedom of choice to select from the standard, amortized fixed payment mortgage (standard mortgage) and any appropriate AMI, * * * ."

The board chairman of a California State-chartered association, who spoke on behalf of the U.S. League of Savings and Loan Associations, said:

"What I'm saying is [the borrower] should have that choice. He certainly should have the choice of obtaining a fixed rate loan, but he also should have the choice of obtaining a VRM."

FHLBB officially recognized the consumer's right to documented choice when it approved its VRM program in 1979. In its May 30, 1979, regulation authorizing VRMs for Federal associations, FHLBB said:

"In order to ensure that consumers would always have a choice between a VRM and a standard fixed-rate mortgage, and that an informed choice could be made, the Bank Board's [preliminary] regulations required that prospective borrowers receive extensive disclosure materials before election of a VRM." [This rule has] been retained. (Emphasis added.)

In March 1980 hearings before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, the FHLBB Chairman justified excluding documented choice by stating that competitive forces in the marketplace would insure the SFPM's availability for interested consumers. He cited as evidence supporting this position the widespread availability of the SFPMs both in the late 1920s when there were no consumer safeguards and in New England and California where VRM instruments have been authorized for a number of years. He also noted that while

comments on the proposed regulation from consumer representatives generally expressed concern about the lack of choice, no lenders advocated choice. He said lenders feared that choice would make marketing of RRMs difficult and greatly slow consumer acceptance.

Some lenders we contacted in California told us that the principal reason for continuing to offer SFPMs with VRMs was the lack of a secondary mortgage market for VRMs. They noted that on loans which do not meet secondary mortgage market requirements and where it is necessary to maintain them in their portfolios, they accept only VRMs.

Consumers desire a choice of mortgage instruments to include SFPMs

Both consumer representatives and the public clearly support the concept of choice. Consumer representatives have stated that without mandated choice many consumers would be precluded from purchasing homes or would be placed in the position of obtaining mortgages they really cannot afford. Senior citizens and others on fixed incomes and persons approaching retirement age are examples of consumers who may face this predicament.

During hearings before the House Subcommittee on Commerce, Consumer and Monetary Affairs in March 1980, consumer representatives strongly condemned the lack of documented choice in the proposed RRM regulations. A representative for the New York State Consumer Protection Board stated, in part, that the omission makes the regulations absolutely unacceptable to the consumer.

Comments submitted during the March 1980 hearings by the U.S. Office of Consumer Affairs included

> "* * *Under the VRM regulations, a consumer must be offered a choice between a VRM or a standard rate mortgage* * * ." Without meaningful choice, consumers can not make informed decisions regarding mortgage financing.
>
> "This choice is unlikely to exist in the marketplace. It has been predicted that the RRM, if adopted as proposed, will be the major (if not only) mortgage instrument available. If a VRM is offered, the institution must also offer a conventional mortgage. Institutions are unlikely to do so since, even at a higher interest rate, the VRM and the conventional mortgage place more business risk on the lender

than does the RRM. Further, the VRM contains far more consumer protections than does this proposal. In a period of limited mortgage money the consumer is unlikely to have the bargaining power to obtain this choice. With choice, the institutions will have to make the RRM attractive and fair to the consumer if it is to be accepted."

A consumer survey addressing mortgage choices supports the viewpoint of consumer representatives. In January 1980, the Joint Center for Urban Studies of MIT and Harvard University published a research paper on consumer attitudes toward AMIs. Commissioned by FHLBB, the survey found that consumers want a choice of mortgage features and instruments. Of the respondents contacted, 80 percent indicated they wanted a choice. When asked which choices should be made available, 92 percent believed that lenders should be required to offer a SFPM. The study was based on a nationwide telephone survey of over 2,000 households selected by means of a random, clustered, probability sample with a follow-up mail survey.

Options available to lenders can reduce the risk of offering SFPMs

SFPMs do not protect lenders from the risk of financial losses stemming from future deposit interest rate increases during inflationary and tight money periods. However, options are available to lenders which can reduce this risk. They include (1) selling SFPM packages on the secondary market and (2) charging borrowers higher interest rates on SFPMs to compensate for the risk of holding such mortgages in their portfolios.

According to the Interagency Task Force on Thrift Institutions, 1/ one option now available to most lenders is the ability to sell SFPM packages either on established secondary mortgage markets or through solicitation and

---

1/The task force was established by the President in March 1980 to study the problems facing thrift institutions and their prospects for the future and to submit findings and recommendations to the President and to the Congress. The task force was comprised of White House Domestic Policy Staff; the Department of the Treasury, HUD, FHLBB, OCC; the Board of Governors of the Federal Reserve System; the Board of Directors of the Federal Deposit Insurance Corporation; and the National Credit Union Administration Board. The report was issued June 30, 1980.

private placement to groups which desire long-term, fixed-rate fund commitments. By using secondary markets, lenders can improve the maturity balance between assets and liabilities and eliminate the threat of future financial losses by holding SFPMs in their portfolios.

Some State-chartered associations in California follow this procedure and provide consumers a choice between a SFPM and the California VRM. Although these associations are not required to offer the consumer a choice, they do so when they are able to sell SFPMs on the secondary market. Since the secondary market prefers smaller loans, these associations also limit the size of SFPMs they will offer. Consumers desiring a larger mortgage amount have to settle for a VRM or seek alternative financing arrangements.

According to the task force, there are no inherent structural or institutional constraints, either in terms of the savings and loan industry or the mortgage market as a whole, on the ability of the savings and loan associations to increase their mortgage sales on the secondary market. The task force pointed out that certain impediments presently reduce some buyers' ability to purchase SFPMs on the secondary market, but that they are now being eliminated.

One impediment identified was that some lenders may not have easy access to secondary markets. The cost of using established secondary markets or soliciting commitments from private sources may seem too high relative to the benefits of selling SFPMs. However, FHLMC and FNMA have significantly improved the marketability of conventional SFPM mortgages by developing standardized mortgage instruments, procedures for selling mortgages, and underwriting criteria. In addition, companies such as private mortgage insurers have recently started insuring certain types of securities backed by conventional SFPM mortgage packages originated and serviced by up to 40 lenders. These instruments give small lenders better access to the secondary markets and reduce the likelihood that such lenders would have to hold SFPMs in their portfolios if they did not want to. The new instruments also help insure that large amounts of loans can be sold quickly at relatively attractive rates.

A second impediment--the willingness of secondary market participants to purchase SFPMs--may wane as knowledge concerning adjustable rate mortgages increases. While virtually all secondary market activity has involved SFPM packages in the past, the increased availability of adjustable rate mortgage packages for sale could increase the secondary market participants' awareness of the benefits of such

instruments and may reduce their desire for SFPMs. However, some potential mortgage investors, such as insurance companies and pension funds, have long-term financial liabilities and, consequently, prefer long-term investments like SFPMs. According to the task force, indications are that if yields are competitive, such institutions will invest in these mortgages. The FHLBB Chairman echoed this statement while speaking at the California Savings and Loan League convention in September 1980. He stated that SFPMs are by no means a thing of the past and many secondary market investors like these mortgages.

The third impediment concerns the issue that some investors interested in long-term, fixed-rate instruments have been reluctant to buy SFPM packages because borrowers usually prepay mortgage loans before their long-term mortgage commitments are terminated, particularly during periods of falling interest rates. However, FHLBB has revised its regulations to offer investors some protection against prepayments.

Finally, the task force noted that Federal and State laws prohibit prospective purchasers from participating in the secondary market. At the Federal level, the Employee Retirement Income Security Act of 1974 (Public Law 93-406) prohibits investing pension funds in mortgage pools involving lenders who service the pension plans. Some State laws restrict the ability of State-chartered pension funds, insurance companies, and, in some cases, State-chartered savings and loan associations and banks to invest in conventional mortgage-backed securities. However, the Department of Labor has proposed to exempt pension funds from restrictions against participation in mortgage pools which include mortgages of lenders who service the funds.

Another way for lenders to reduce the risk of mismatched, long-term, fixed-rate assets and short-term, volatile deposits is to charge borrowers higher interest rates for SFPMs. Such a practice is already common among lenders who offer consumers a choice between SFPMs and VRMs.

Thus, if consumers desire an SFPM, they could obtain one if they are willing to pay higher rates than what they could obtain on a comparable adjustable rate mortgage. The lender, in turn, would receive compensation for assuming the risk of future interest rate fluctuations.

The concept of charging higher interest rates on SFPMs in lieu of eliminating them is not a new idea. In 1975, a former Federal Reserve District Bank President discussing new

mortgage designs stated that a SFPM should not be eliminated, but it should be offered at a significantly higher rate than the variable-rate mortgage. Similarly, an economist who critiqued the Alternative Mortgage Instruments Research Study stated that the inability to accurately forecast future interest rates would presumably result in larger risk premiums, but by itself need not call for replacing fixed rate mortgages.

Higher interest rates on SFPMs will not eliminate the risk of future financial losses because interest rates are not easy to forecast. The lender could enjoy unexpected profits but could experience unexpected losses as well. In addition, competitive pressures or the desire to increase one's share of the local mortgage market could cause some lenders to lose sight of future risk and to lower SFPM interest rates below warranted levels.

Federal adjustable rate mortgages need more comprehensive disclosure requirements

Although FHLBB's VRM regulation provides the consumer with full disclosure information on total costs of a mortgage loan, neither FHLBB's RRM or AML regulations nor OCC's ARM regulation provide consumers adequate information with which to fully assess the impact of these instruments on their future financial conditions. Specifically, the disclosure provisions do not require lenders to inform prospective borrowers of all potential monthly mortgage payment increases which they could face over the life of their mortgage commitments.

When consumers sign a typical mortgage contract, they commit themselves to a long period of monthly mortgage payments which are one of their largest continuing out-of-pocket expenses. Consequently, potential changes in monthly mortgage payments over time could have a significant impact on consumers' future financial viability. Without information on total potential mortgage costs, consumers may commit themselves to a mortgage they would otherwise not desire, or take risks that they would not otherwise take.

However, neither FHLBB's RRM or AML regulations nor OCC's ARM regulation require a lender to disclose adequate information on potential changes in the monthly mortgage payments applicable to prospective borrowers' desired mortgage contract amount. In the case of FHLBB's RRM regulation, lenders are required to inform prospective borrowers of what would happen to a mortgage payment on a "representative" $50,000 mortgage if interest rates increased the maximum

extent possible for a specific period of time. Under OCC's regulation, lenders are required to provide the borrower with examples of interest rate and payment changes over several years.

FHLBB's RRM regulation limits this representative disclosure to only the first note renewal period, thus providing no information on potential changes applicable to subsequent note renewals. For example, the worst case monthly payment increase on a 3-year RRM at the first note renewal period could represent as little as 30 percent of total possible monthly payment changes. The maximum monthly payment in a worst case situation would not occur until the fourth note renewal period, 12 years from the date the mortgage contract is signed.

Comments received by FHLBB criticized the proposed RRM regulations before they were finalized for not containing the same disclosure safeguards as the VRM. For example, the Federal Trade Commission wrote:

> "The initial notice discloses only those costs associated with the short term loan, and the renewal notice only those costs for the new loan term. Neither specifies the 'worst case' costs for the life of the mortgage, a disclosure currently required by the Bank Board for variable rate mortgages. While short term costs are of interest to consumers, especially in deciding whether they can meet the monthly payments required, full disclosure of long-term costs is necessary to correctly reflect the total cost and provide for meaningful and comparable information. For example, if a consumer receives only short-term data, comparison of the rollover with standard fixed rate mortgages, variable rate mortgages and other mortgage instruments is impossible. Unfortunately, many consumers are not sophisticated in mortgage finance. Some may utilize short-term data in comparison credit shopping not realizing that the full mortgage costs are far in excess of quoted information. Thus, full cost disclosures are necessary to facilitate wise and informed credit decisions."

Lenders have taken exception to the disclosure requirements contained in FHLBB's VRM regulations, claiming excessive paperwork burdens. Such comments were also provided to FHLBB by lenders responding to the proposed RRM regulations. In the regulation authorizing the RRM, FHLBB defended its

decision to exclude a worst case disclosure provision by stating that:

> "* * *the Board intends the disclosures to be provided prior to actual application, so that the borrower understands the nature of the credit instrument which may be offered before paying an application fee. Therefore, the disclosure cannot be instrument-specific, relative to rates and payments, because the loan has not been processed and commitment terms change frequently. With regard to a more extensive 'worst case' disclosure, the Board believes that RRMs should be allowed to be competitive with other mortgage instruments, and notes that Truth-In-Lending statements will continue to provide specific credit information in addition to the Board's required early disclosure material."

Limitations on interest rate caps should be standardized after study

FHLBB established interest rate cap structures on its VRM mortgage instrument without first studying their impact on consumers and lenders. The new AML authorized by FHLBB does not have interest rate caps. OCC's ARM has imposed a 1-percent limitation on interest rate increases every 6 months, but no overall limitation. FHLBB's Chief Economist told us that interest rate caps were established on the basis of congressional concern for consumer safeguards. He said they were not based on objective socioeconomic studies. An OCC representative also told us that no studies were conducted.

To obtain an idea of the potential impact of upside interest rate cap structures on consumers accepting an adjustable rate mortgage, we made limited analyses of the effect that various interest rate cap structures would have on discretionary incomes. 1/ Our analyses were limited to worst-case situations and hypothetical borrowers using FHLBB's RRM. We limited our analyses to FHLBB's RRM rather than its VRM because RRM presently has a potentially greater adverse financial impact on consumers.

1/We defined discretionary income as the amount left after subtracting consumption and housing costs from a consumer's total income. It is available for either savings, miscellaneous purchases, or monthly mortgage payment increases.

Our analyses showed that a hypothetical 3-year RRM borrower experiencing average annual increases in income and in consumption expenses during a 10-year period beginning in 1971 would have been adequately protected by RRM's present 0.5 percent annual and 5 percent overall upside interest rate cap structure. This is also true for a projected 10-year period beginning in 1981. Our analyses showed that the borrowers had adequate discretionary income to pay the higher monthly mortgage payments allowed by the interest rate cap structures.

However, our analyses do not address the potential impact of RRM's upside interest rate caps on all prospective borrowers, some of whom may experience little or no increases in their income. In addition, after we made our analyses, OCC issued its ARM and FHLBB issued its AML and neither instrument provides for overall caps--OCC's ARM does have a 1-percent limitation on increases for every 6 months--and both instruments provide for the computation of negative amortization. Allowing the interest rate to float with one of several indexes along with the more frequent adjustments allowed every 6 months under OCC's regulations and 1 month under FHLBB's new AML will increase the number of consumers that might experience problems with the larger mortgage payments.

Our analyses of RRM's upside interest rate cap structure show that the discretionary incomes of some borrowers as a percentage of total income will increase on the average after payments are made under worst-case situations. Also, even with higher than currently permitted interest rate cap structures these borrowers will generally experience discretionary income percentage increases in worst-case situations. This result is obtained for the historical 1971-80 period, as well as the projected 1981-90 period.

In our analyses, we compared the traditional SFPM, FHLBB's 3-year RRM, with the present interest rate cap structure, and several hypothetical RRMs having alternative interest rate cap structures. The alternative structures analyzed included various combinations of 1, 1.5, and 2 percent annual caps and 5 and 10 percent overall caps, as well as no overall cap.

Our analyses were based on a variation of a four-person family's total income and consumption for the two 10-year periods. Data for the 10-year period starting in 1971 generally came from the Bureau of Labor Statistics, and data for the 10-year period starting in 1981 came from Data Resources, Inc., a private economic research and forecasting

firm. 1/ We did not examine the basis for the 1981 to 1990 projections or determine their sensitivity to changing economic situations. We also did not determine the sensitivity of income and consumption statistics and projections to those economic factors which influence interest rates.

Our analyses contained several assumptions. First, they assumed that a hypothetical RRM borrower purchased a home in January 1970 and January 1980. The home purchased in 1970 cost $36,100 and was financed with a $28,880 mortgage at an inital interest rate of 8.34 percent. The 1980 home cost $76,900 and was financed with a $61,520 mortgage at 11.89 percent. These figures were chosen to closely approximate situations existing at those times. Second, the analyses assumed that the instrument financing the purchases were 3-year RRMs. We chose the 3-year RRM since that instrument permits the quickest monthly mortgage payment increase of any presently authorized RRM. Two of the analyses assumed worst-case situations with mortgage interest rates increasing the maximum amount allowed under each interest rate cap structure for the entire 10-year period. One of the 1971-80 analyses is based on historical interest rate changes, and one of the 1981-90 analyses is based on projections of interest rate changes during the 1980s supplied by Data Resources, Inc.

Analysis of discretionary income

For our sensitivity analysis we assumed that discretionary income was equal to the difference between income and total consumption. Consumption was defined by a constant basket of goods and services whose costs change over time. One component of this basket is mortgage principal and interest payments. The graph on page 34 shows several comparisons for households, assuming that they have either a SFPM or a 3-year RRM.

The two lines representing the SFPM and the 3-year RRM show the differences in yearly payments for principal and interest for these types of mortgages. The spread between the lines represents increased cost to the households. The other lines compare income to total consumption costs for the SFPM and the 3-year RRM. As can be seen in the chart,

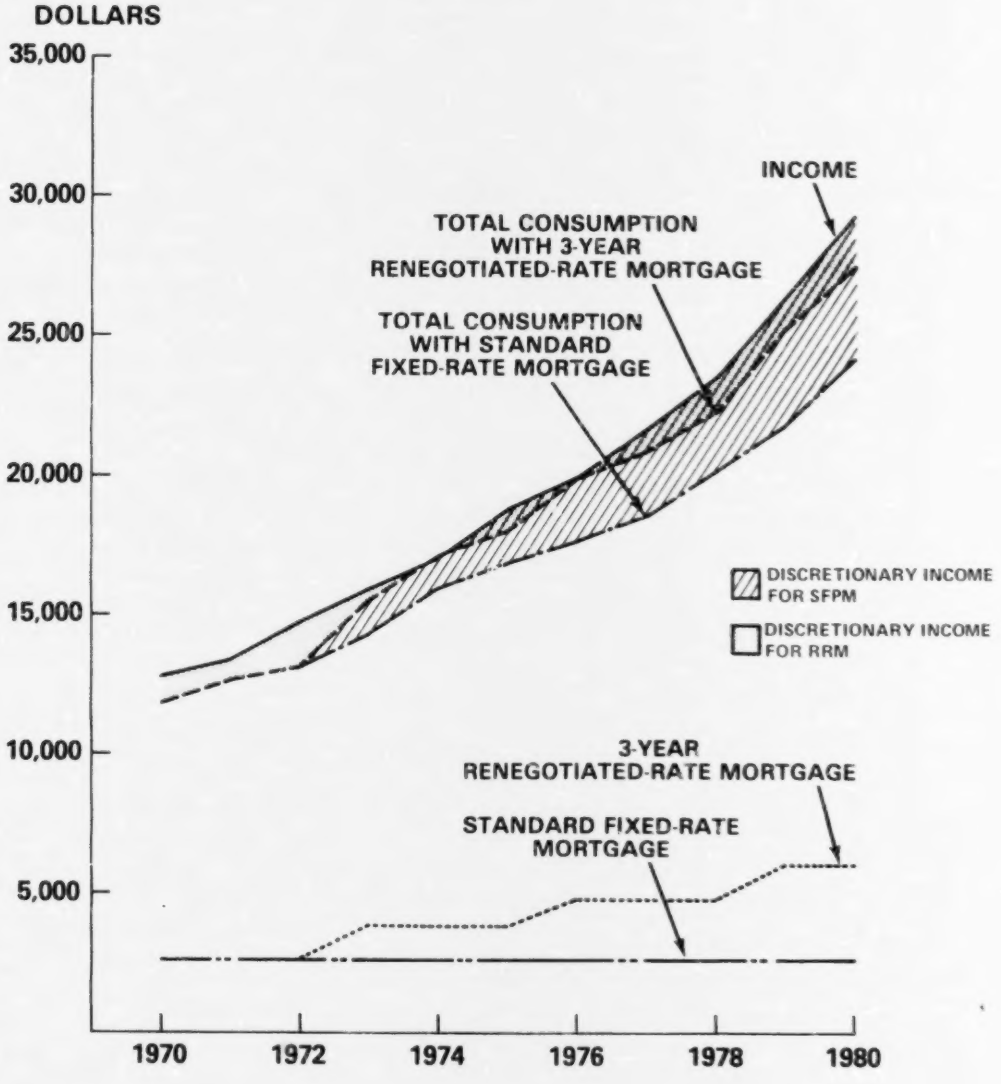
---

1/Chapter 5 contains the methodology used to develop the income, consumption, and housing cost statistics as well as tables which summarize the data.

the SFPM household has more discretionary income than the 3-year RRM household.

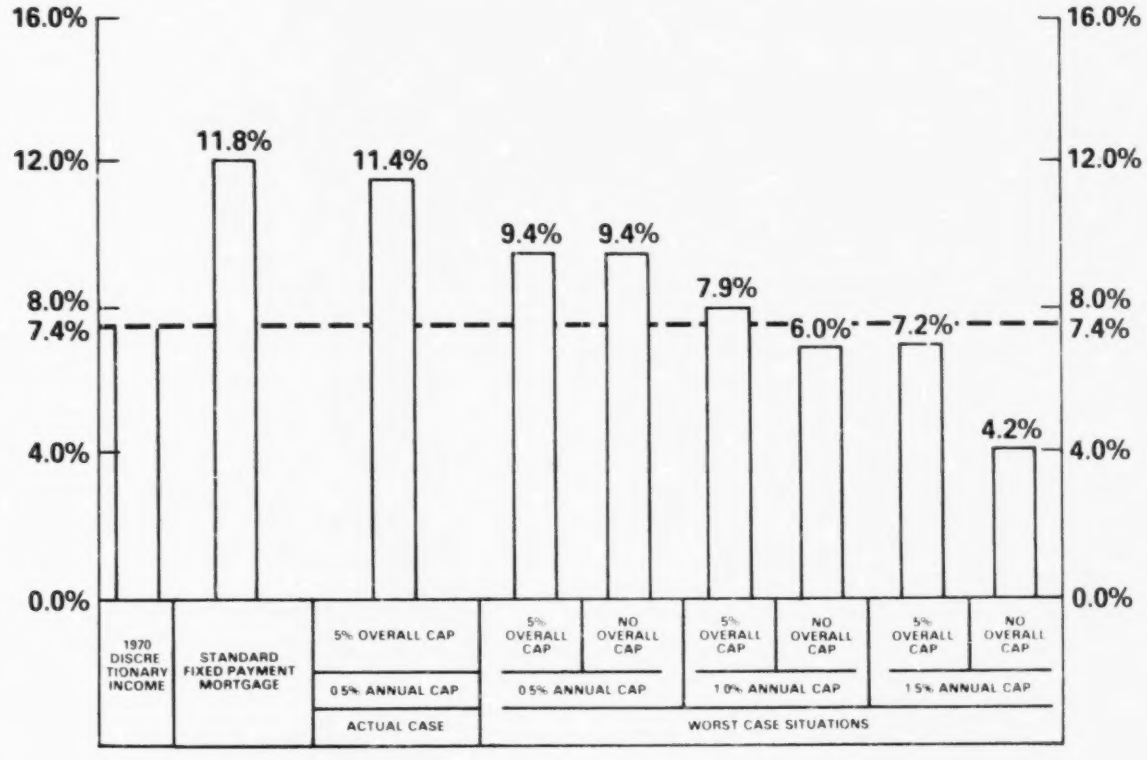
By calculating the dollar amount between the lines and dividing it by the income figure, a percentage of incomes is determined. The following graph presents a display of a number of sensitivity analyses that we performed during our review.

CHANGES IN HOUSEHOLD DISCRETIONARY INCOME USING A STANDARD MORTGAGE COMPARED WITH A 3-YEAR RENEGOTIATED-RATE MORTGAGE FOR THE PERIOD 1970 TO 1980



The bar graphs on pages 35 and 37 summarize the results of our analyses. The graphs show what happens to discretionary income as a percentage of total income for the SFPM, the presently authorized RRM, and a number of hypothetical worst case RRMs averaged over two 10-year periods beginning in 1971 and 1981. The 1970 3-year RRM based on actual interest rate changes and the 1980 3-year RRM based on projected interest rate changes are also shown. The 1970 and 1980 discretionary income percentages are shown as a reference.

COMPARISON OF HOMEOWNER'S DISCRETIONARY INCOME AS A PERCENTAGE OF TOTAL INCOME AVERAGED OVER THE 10-YEAR PERIOD: 1971-80 FOR A 1970 SFPM AND VARIOUS 1970 3-YEAR RRM USING SEVERAL ALTERNATIVE INTEREST RATE CAP STRUCTURES



The graph on page 35 shows the results of our analyses of hypothetical borrowers who purchased homes in January 1970. It also shows discretionary income as a percent of total income--7.4 percent for the borrowers in 1970. We averaged the discretionary income for the various sensitivity analyses for the 10-year period.

In general, discretionary income percentages would have increased or remained about the same in all cases except the worst-case 3-year RRM with a 1.5-percent annual cap and no overall cap. SFPM would have provided the greatest percentage increase, and the presently authorized 0.5 percent RRM would have performed nearly as well based on historical interest rate changes.

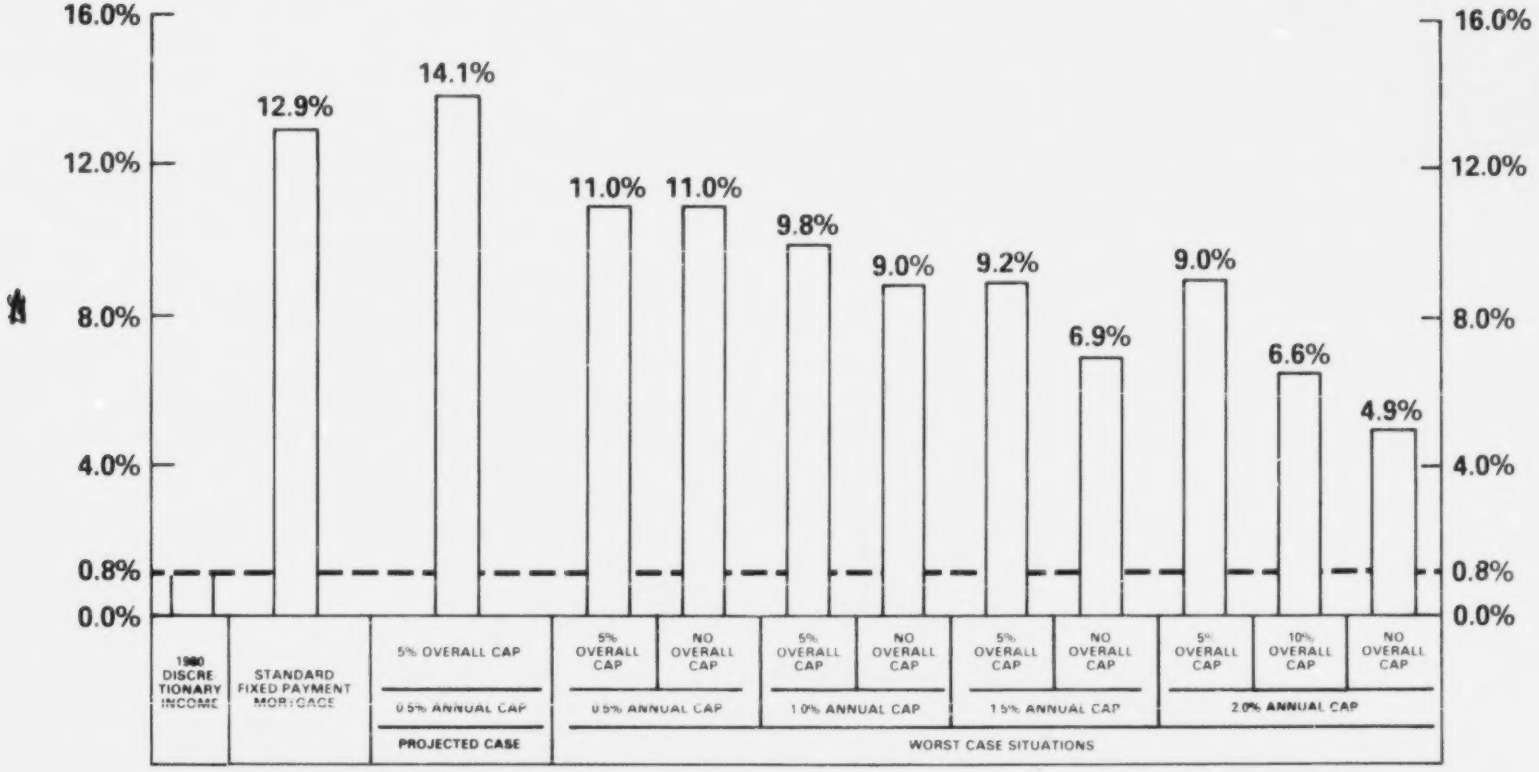
In the worst-case situations, the 0.5 percent, 3-year RRM, with or without a 5-percent overall cap, and the 1 percent, 3-year RRM with a 5-percent overall cap, would also have allowed discretionary income percentage increases. The 1 percent, 3-year RRM without an overall cap and the 1.5 percent, 3-year RRM with a 5-percent overall cap, would have caused slight decreases in average discretionary income percentages. The 1.5-percent, 3-year RRM without an overall cap clearly would have resulted in lower average discretionary income percentages over the 10-year period.

The graph on page 37 shows the results of our analyses of hypothetical borrowers who purchased homes in January 1980. The discretionary income percentage was 0.8 percent for all borrowers in 1980. We averaged the discretionary income for the various sensitivity analyses for the 10-year period.

Average discretionary income percentages increased in all analyzed cases over the 10-year period. The largest increase was the presently authorized 0.5 percent, 3-year RRM based on projected interest rates for the period. It outperformed the SFPM because of an expected decrease in interest rates during part of the 10-year period.

Under worst-case situations, all 3-year RRMs with 5 percent overall caps, including one with a 2-percent annual cap, provided very good increases in discretionary income percentages. Interestingly, even a 3-year RRM with a 2-percent annual cap and no overall cap would have provided an increase over the 10-year period.

COMPARISON OF HOMEOWNER'S DISCRETIONARY INCOME AS A PERCENTAGE OF TOTAL INCOME AVERAGED OVER THE 10-YEAR PERIOD: 1981-90 FOR A 1970 SFPM AND VARIOUS 1970 3-YEAR RRM USING SEVERAL ALTERNATIVE INTEREST RATE CAP STRUCTURES



FHLBB's RRM and VRM regulations limit decreases of interest rates to 0.5 percent annually (e.g., 1.5 percent at renewal time for a 3-year RRM and 5 percent overall). Hence, RRM and VRM borrowers may be denied from benefiting if interest rates decline at a more rapid rate. If the indexes decrease more than an average of 50 basis points 1/ annually, then existing borrowers will be forced to renew their RRMs or make VRM payments at an interest rate above what the index would otherwise permit. Borrowers would face a similar situation if the indexes decrease by more than 5 percent overall.

On the other hand, OCC's regulation permits the lender to reduce effective mortgage interest rates at any time without regard to interest rate index or interest rate caps. This provision reduces the possibility of borrowers being "locked-in" to a higher than necessary mortgage interest rate for an extended period of time. This possibility would be precluded altogether if all Federal adjustable rate mortgage regulations required lenders to reduce interest rates at least as much as the decline indicated by the applicable interest rate index without limitations.

To illustrate this situation, assume a hypothetical RRM borrower purchases a home in April 1980 financing it with a $60,000, 3-year RRM at 17 percent. Assume that the RRM index is at 1,700 basis points in April 1980 and decreases 500 basis points to 1,200 by April 1983.

The initial monthly mortgage payment of the hypothetical borrower would be $855 in April 1980. Upon renewal, in April 1983, the renewal interest rate, by regulation, will be 15.5 percent and the new monthly mortgage payments will be $784. Without downside interest rate caps, the renewal interest rates would be 12 percent in accordance with the decline in the RRM index, and payments would be $622 or about $162 less a month. Thus, without caps, the borrower would have recognized significant out-of-pocket savings of $5,826 over the subsequent 3-year period.

The following table summarizes the impact of downside interest rate caps on hypothetical RRM borrowers. Case I shows the hypothetical RRM borrower who faces downside interest rate caps. Case II shows the RRM borrower without downside interest rate caps.

1/One basis point equals 0.01 percent. Thus, a decline of 50 basis points equals a decline of 0.5 percent.

Viewed from the lender's perspective, since the RRM index is the FHLBB's national average mortgage rate index for the purchase of previously occupied homes, the lender's prevailing mortgage rate in case II will closely approximate 12 percent at the time of the existing borrower's note renewal. Hence, the lender would be making new mortgage loans at 12 percent interest while renewing the RRM mortgage note at 15.5 percent interest.

Computation of Potential Savings Available to RRM Borrowers Without Downside Interest Rate Caps

Case	Dates	RRM index	Effective interest rate	Monthly payment	Total payments
			(percent)		
I	4/80-3/83	1,700	17.0	$855	$30,794
	4/83-3/86	1,200	15.5	784	28,234
					59,028
II	4/80-3/83	1,700	17.0	855	30,794
	4/83-3/86	1,200	12.0	622	22,408
					53,202
	Total				$ 5,826

At present, the hypothetical case I RRM borrower has only one course of action which can reduce the amount of monthly mortgage payments. When interest rates decline lower than the limitation, they can prepay the existing loan and refinance at prevailing rates with other lenders. If it is financially advantageous, they can prepay the mortgage before the renewal dates and incur prepayment penalties in those States where such costs are applicable. Otherwise, they can wait for the note to mature and prepay without penalties. In either case, new loan closing costs will reduce, if not eliminate, the potential savings available.

In commenting on the report, the FHLBB indicated that it was unrealistic that a borrower would be locked into a loan at a rate 3-1/2 percentage points above the market. We disagree with the FHLBB's view that our example of lenders originating new mortgage loans at 12 percent while renewing RRMs at a rate of 15.5 is unrealistic. The same economic conditions which drove mortgage interest rates from under 10 percent to as high as 17 percent in less than 5-years could easily work in reverse. The differential used in our

example was based on actual mortgage interest rate changes that took place during 1980. The rate dropped from 17 percent in the spring to 12 percent by the fall of 1980.

Consumers should have a wider choice in selecting note maturity dates

Federal regulators that offer adjustable rate mortgages need to determine if consumers should be provided a wider choice of note maturity dates, along with the option to select the note maturity date which best suits their individual financial circumstances. Also, regulators need to determine if the option should be available to consumers both at the time the mortgage contract is signed and at the various note renewal periods.

FHLBB does not offer these options to consumers. Specifically, RRM regulations do not authorize short-term 1-year and 2-year RRMs to consumers. In addition, RRM regulations state that lenders have the exclusive option to select which authorized RRM note maturity dates to offer. The regulations also stipulate that once prospective borrowers accept one of the three presently authorized RRM note maturity dates, they cannot change the note maturity length when the loan is renewed.

Because the new types of mortgage instruments are placing increased risk upon borrowers, we believe that they need options to help them more effectively manage risk and minimize the potentially adverse financial impact of future interest rate increases. Morever, Canadian borrowers generally have a choice of Canadian rollover mortgage note maturity dates both at loan closing and at loan renegotiation.

RRM borrowers may need more flexibility to better manage the financial risk they assume

As RRM borrowers, consumers commit themselves to a series of periodic interest rate adjustments. Each time an RRM borrower's mortgage note underlying his or her mortgage commitment is renewed, the borrower receives a new interest rate which, subject to annual and overall interest rate caps, closely approximates the lender's prevailing mortgage rate at the time of renewal. Thus, RRM borrowers are faced with the continuing prospect of large monthly mortgage payment increases upon note renewal, although they might enjoy large reductions as well.

Under the current RRM regulations, prospective borrowers are only offered either a 3-year, 4-year, or 5-year RRM note

maturity date depending on what the lender is willing to offer. In addition, RRM borrowers must keep this note maturity length each time they renew the note or until they prepay the mortgage. They cannot vary the length of each subsequent note even though the interest rate environment is such that a shorter or longer note may be in their best financial interests.

Alternatives that can be made available to RRM borrowers include allowing borrowers to initially choose RRM note maturities, revise the maturity at note renewal, and have the right to choose short-term 1-year or 2-year maturities. With such flexibility, the best course of action for RRM borrowers when interest rates appear relatively low is to "lock-in" the prevailing rate as long as possible. If interest rates appear high at the time of renewal, they could then lock-in the high rate for as short a period as possible, preferably 1 year. If they are uncertain as to future interest rate changes, they may wish to select an intermediate-term RRM note.

Thus, RRM borrowers with these options have the flexibility to properly manage the interest rate risk they assume in accordance with their financial perception of future interest rate changes. Borrowers with no options do not have similar flexibility. The latter borrowers could prepay their loans during a low-interest rate period and solicit other lenders, but then they would have to weigh the prepayment costs, new loan origination costs, and other loan closing costs against the possible out-of-pocket savings.

The table on page 42 illustrates the potential savings available to RRM borrowers who have options. Three cases are presented. In each case consumers initially finance $60,000 RRMs over 30 years in April 1980 at 17 percent. Case III represents a RRM borrower without options who is offered a 3-year RRM. Case IV represents a RRM borrower with options who initially selects a 1-year RRM, but is restricted to an annual 0.5 percent interest rate reduction in accordance with present RRM regulations. Case V represents a RRM borrower with options who also initially selected a 1-year RRM, but with no downside interest rate caps. The assumptions used include (1) prevailing mortgage interest rates will drop to 12 percent by April 1981 and remain at or below 12 percent through April 1982 and (2) the RRM index stands at 1,700 basis points in April 1980, falls to 1,200 basis points by April 1981, and does not rise above that point until after April 1982.

In case III, RRM borrowers with no flexibility must make 36 monthly payments of $855 at the initial 17 percent rate. Their total payments over the 3-year period are $30,794.

In case IV, flexible RRM borrowers will realize out-of-pocket savings compared to case III RRM borrowers. With their 1-year RRMs at 17 percent, they make 12 monthly payments of $855. In April 1981 they refinance the remaining principle with another 1-year RRM at 16.5 percent and thus make monthly payments of $831 over the second 12-month period. Similarly, they again refinance in April 1982 at 16 percent making monthly payments of $807 during the third 12-month period. Their total payments are $29,929 for a net savings of $865 over case III borrowers.

Computation of Potential Savings Available to Consumers Who Can Select Desired RRM Note Maturity Dates Ranging from 1 to 5 Years

Months	Case III	Case IV	Case V
1-12	$ 855	$ 855	$ 855
13-24	855	831	618
25-36	855	807	618
1-36	30,794	29,929	25,114
Total	$ 0	$ 865	$ 5,680

Case V provides the most dramatic illustration of potential out-of-pocket savings available to a flexible RRM borrower. The case V borrower also initially makes 12 monthly payments of $855. However, in April 1981 if they are satisfied that interest rates will go no lower, they can refinance with 5-year RRMs at 12 percent with monthly payments of $618 on the remaining principal. Over the 3-year period from April 1980 through March 1983, their monthly payments total $25,114. This represents a total out-of-pocket savings of $5,680 over case III RRM borrowers.

The estimated savings available to the case V, flexible, RRM borrowers could be reduced to some extent because lenders may charge an add-on interest rate differential for a 5-year RRM over a 1-year RRM. The differential might be necessary to compensate lenders for the greater cost incurred if they choose to match the longer term RRM note against longer term, more expensive deposit liabilities. Nevertheless, case V borrowers clearly stand to benefit from lower out-of-pocket payments because they are provided options with which to properly manage their financial affairs.

Canadian borrowers can select mortgage note term

The principal on a Canadian rollover mortgage is amortized over a 25- to 35-year period and financed by a series of short-term notes with maturity terms which do not exceed 5 years. Canadian lending institutions permit borrowers to initially select from a full range of authorized mortgage notes, including 1- and 2-year notes. During the recent high-interest rate period, some lenders were even offering 6-month mortgage notes. While Canadian lenders are not required to offer a mortgage note with any particular maturity, competition has forced them to make the full range of maturities available. Upon note renewal, the borrower can change the mortgage note to any maturity which the lender offers. Hence, Canadian borrowers have the options necessary to minimize the potential adverse impact of high-interest rates on their out-of-pocket payments.

RECENT AMI PROPOSALS BY FHLBB

On September 30, 1980, FHLBB proposed two new AMIs, the shared appreciation mortgage and the graduated payment adjustable mortgage (GPAM). With the shared appreciation mortgage, the borrower agrees to share the property's appreciation with the lender in return for an interest rate below that on a standard mortgage. GPAM combines the adjustable interest rate feature of the RRM with the graduated payment feature of the graduated payment mortgage.

Shared appreciation mortgage

The primary reason for a shared appreciation mortgage is that the lower interest rate, and hence the lower monthly payments, qualifies more households for homeownership. In return for the lower fixed interest rate, the borrower agrees to pay the lender a specified share of the appreciation of the property securing the loan, payable at the earlier of the sale or transfer of the property, or the maturity date of the loan.

The proposed regulations limit the shared appreciation mortgage to a term not to exceed 10 years, with guaranteed long-term refinancing. The monthly payments during the term of the loan are based on an amortization schedule of up to 40 years. At the sale or transfer of the property, or maturity or payment in full of the loan, whichever comes first, the loan is due and the contingent interest must be paid. If the property is not sold, the lender must guarantee to refinance the outstanding indebtedness and contingent interest with a long-term mortgage

made at the then-prevailing market rate. The borrower may prepay the loan at any time without penalty.

The specified share may not exceed 40 percent of the appreciation of the property. In addition, the proposed regulation requires that certain convenants be included in the mortgage contract to ensure the existence of a debtor-creditor relationship between the household and the association. Included is a covenant specifying that the borrower has unrestricted rights to sell, improve, or transfer the property. Both the limit on the contingent interest payment and the covenants are included to ensure that the lender is not an equity investor in the property.

While any borrower desiring lower monthly mortgage payments could consider this instrument, FHLBB believes the shared appreciations mortgage is likely to be attractive to a limited segment of home buyers. The below-market interest rate allows more households to qualify for a mortgage. Thus, the shared appreciation mortgage could appeal to current renters with low and moderate incomes, affording a sizable potential benefit to this group.

Graduated payment adjustable mortgage

GPAM would provide an additional instrument for mortgage lending which will both improve the ability of households to qualify for mortgages and provide savings and loans with needed interest rate flexibility.

GPAM differs from conventional, fixed-rate mortgages in two respects. First, during the early years of the loan, monthly payments are lower than they would be on a standard mortgage, or even on a mortgage with an adjustable interest rate, and are not sufficient to cover the interest being charged on the loan. As a result, the outstanding principal balance on the loan actually increases somewhat during these years.

To compensate for the initial, lower payments, monthly payments increase gradually each year during a period up to 10 years, until they reach a level sufficient to pay all interest and principal by the end of the loan term. The amount of the maximum payment increase due to the graduation feature varies from 7.5 percent per year for a 5-year graduation period to 3 percent for a 10-year graduation period. The length of the graduation period is established as a matter of negotiation between the borrower and the association.

Second, the interest rate on a GPAM may be adjusted up or down every 3, 4, or 5 years. As a result, in addition to increases in monthly payments due to the graduation feature, payments may also increase due to an adjustment in the interest rate. However, there would be a 15-percent limit on the dollar amount by which the monthly payments could increase from one year to the next during the graduation period. The graduation feature and the 15-percent limit are calculated to ensure that increases in a borrower's monthly payments would not, in most cases, be unduly burdensome.

CONCLUSIONS

Federal regulators have authorized adjustable rate mortgage regulations which do not contain consistent consumer safeguards. As a result, some consumers obtaining adjustable rate mortgages from federally chartered lending institutions may obtain greater safeguards than others. To better balance the needs of the lenders and homeowners, we believe that Federal regulators need to standardize certain features of their adjustable rate mortgage regulations.

In the early design work involving alternative mortgage instruments, the need to achieve a balance between consumer safeguards and the financial problems being faced by lenders was highly controversial. Both the Congress and consumer groups expressed concern that the borrower needs to be provided a choice of a SFPM and with sufficient information to properly analyze the new type of instrument being offered. Consequently, FHLBB's regulations for VRM required that a borrower be provided with both a choice of a standard mortgage and adequate disclosure information on a worst-case situation. Both of these requirements have turned out to be unpopular with lenders, and the VRM program has not been widely used nationwide. Moreover, the more recent mortgage instruments authorized have deleted the provision for consumer choice of a standard mortgage and have significantly reduced the disclosure information provided to home buyers.

Concerning the choice of a standard mortgage, we recognize that lenders are being asked to make long-term mortgage loans in an inflationary environment coupled with the high cost of borrowing funds and rapidly rising home prices. However, we believe that all alternatives have not been explored by the Federal regulators for resolving the profit squeeze on the lenders. For instance, the secondary mortgage market has not been utilized fully. Also, the concept of charging a premium for standard mortgages might offer potential for maintaining this mortgage. It might be

that the standard mortgage could be made available only for mortgages of specified dollar amounts or less.

Regarding disclosure requirements, we believe that the type of information required under FHLBB's December 1978 regulations for VRM should serve as a model. However, both FHLBB and OCC have since authorized a major shift in the type of information that will be disclosed to home buyers. The home buyer will no longer be given a side-by-side comparison of the standard mortgage payments and the alternative mortgage being offered. Rather, the home buyer is to be provided with narrative information explaining the difference between a standard mortgage and the alternative being offered. We believe that it is essential that home buyers be provided with quantitative data which will enable them to see and compare what the monthly mortgage payments will be over the total life of the loan. Moreover, we believe that the home buyer should be provided with information on the approximate total cost of the loan.

We recognize that mortgage instruments are complex and that simplifying the consumer safeguard requirements is no easy task. Also, we are aware of the divergent interests of the various groups involved in any effort to develop uniform consumer requirements. However, we believe that the various alternative mortgage instruments being offered or that contain different consumer provisions can only cause confusion for consumers and impede the sale of such mortgages on the secondary mortgage market. We believe also that there is an urgent need to develop, to the maximum extent possible, uniform requirements which are essential for consumer understanding of the instruments as well as the development of a viable secondary mortgage market for such instruments.

AGENCY COMMENTS AND OUR EVALUATION

FHLBB disagreed generally with our recommendations on choice of a SFPM, disclosure requirements, determining whether borrowers should be allowed to select note maturity dates, and the need to study the interest rate cap structures. (See app. III.) FHLBB stated that the report does not recognize the complexity of interactions between consumer safeguards and the lender's ultimate ability to make mortgage financing available through adjustable rate mortgages.

Regarding simultaneously offering SFPMs and making worst-case disclosures, FHLBB stated that recent experience has indicated that when lenders are required to do this, they have been unable to originate a significant amount of

adjustable rate mortgages. FHLBB stated that such requirements make it difficult for the lender to originate adjustable rate mortgages without offering lower than market rates of interest on the adjustable rate mortgage or liberalizing terms to such an extent that the lender is provided no assurance that it can operate profitably and support its liabilities.

The FHLBB authorized the VRM to partially resolve the problem of savings and loan associations paying competitive short-term deposit rates during periods of cyclically high interest rates and lending on long-term SFPMs. The VRM was supposed to balance associations' asset-liability mix sufficiently to maintain an acceptable earnings stream. It was recognized that the VRM transferred some of the interest rate risk previously borne by the lender on SFPMs to mortgage borrowers. The FHLBB anticipated that the initial rate on VRMs would be somewhat lower than on a SFPM to compensate for the different risk factors.

Regarding the requirement that borrowers be given a choice between the SFPM and AMI offered, it should be noted as discussed on page 23 that FHLBB advised a congressional oversight committee--in testimony on the authorization for the VRM--that providing borrowers a choice of mortgage instruments appeared to be the most important of the borrower safeguards. This conclusion was based on a comprehensive research effort involving 20 separate research projects to study alternative new designs for the residential mortgage, the results of which were published by FHLBB in the November 1977 Alternative Mortgage Instruments Research Study. Moreover, several officials of national organizations which represent savings and loan associations expressed strong support for the borrower's right to choose between a SFPM and the AMI being offered.

We recognize that economic conditions have worsened since the FHLBB first introduced its VRM in 1979. We agree also that increased pressures have been placed on associations because of (1) the phaseout of interest rate ceilings on savings and deposit accounts, (2) the high costs of short-term funds, and (3) increased competition from national and State banks in the mortgage area. Moreover, FHLBB indicated that poor earnings, and in many cases losses, are resulting from the difference between the high and volatile cost of market-related savings and the low-yield on SFPM portfolios.

Although the initial FHLBB VRM instrument was designed to alleviate many of the problems associated with the SFPM,

we believe that lenders have not used the VRM instrument to any significant degree to form a basis for concluding whether or not the instrument has potential for aiding the lenders' poor earning conditions. We believe no mortgage instrument will provide an immediate cure for mortgages which were written many years ago and carry low interest rates. Also, while the FHLBB raised arguments on losses sustained on loans being written for 30 years or more, it should be noted that the average life of a single-family loan is about 10 years.

While we are aware of the FHLBB's arguments against continued use of the SFPM, we noted that the concept of charging a higher interest rate on such mortgages in lieu of eliminating them was proposed by a member of the FHLBB system. Also, the Alternative Mortgage Instruments Research Study indicated that the inability to accurately forecast future interest rates would presumably result in larger risk premiums, but by itself need not call for replacing the SFPM. (See p. 29.)

Regarding full disclosure requirements, we continue to believe that, in order to make informed credit decisions, borrowers have a need to know the possible payments they may experience over the life of the mortgage. We recognize that borrowers might not experience the maximum payment allowed by the interest caps; however, providing them with an estimate of the maximum payment does serve to warn them of the extent of their payment liability.

Under the RRM, borrowers will be provided with disclosure information on costs applicable to a $50,000 representative mortgage for the short-term loan. No estimated cost information will be provided for the life of the mortgage. In effect, the information provided to the borrower is so limited that a comparison of AMIs, including the SFPM, is nearly impossible.

Regarding our observations on minimizing risks of SFPMs through secondary market purchases of mortgages, FHLBB stated that there is limited capacity to buy mortgages, particularly during tight credit periods. However, it should be noted that the Treasury Interagency Task Force on Thrift Institutions' report, as discussed on page 26, stated that there are no inherent structural or institutional constraints, either in terms of the savings and loan industry or the mortgage market as a whole, on the ability of associations to increase their sales of mortgages on the secondary market. The task force indicated that the major inhibiting factors are likely to be an unwillingness to change established modes of oper-

ations and a lack of marketing expertise. The task force concluded that the secondary market has become highly sophisticated and associations might have to hire persons knowledgeable in mortgage banking operations.

Regarding our observations on allowing borrowers to select the length of the RRM note term, the FHLBB indicated that such action would create uncertainty for the lender in portfolio management and in determining a fair interest rate at the time of origination. Also, the FHLBB stated that this option would pose a serious impediment to the development of a secondary mortgage market in adjustable rate loans because the ability to group together loans of uniform characteristics is crucial because the secondary market in mortgage-backed securities must have the ability to account for loans on a group basis.

We recognize that there might be disadvantages to allowing borrowers to select the note maturity dates. Consequently, we did not recommend that borrowers be given a choice of different note maturity dates; rather, we recommended that FHLBB determine whether borrowers should be given the option of different note maturity dates than now offered. We recognize that secondary market considerations may dictate the eventual requirements necessary for pooling such mortgages. Accordingly, we believe that experimenting with the borrower option should be studied and let the market place decide whether the option has merit for implementation. We believe that as a minimum the advantages and disadvantages from the borrowers' and lenders' viewpoint should be more fully explored by FHLBB.

FHLBB stated that our comparison of the RRM with the Canadian rollover mortgage was inappropriate and somewhat misleading, as that instrument truly contemplates a series of loans. Our purpose was not to demonstrate the instrument specifics between the Canadian rollover mortgage and FHLBB's RRM, but simply to note that the Canadian borrower is offered the option of selecting the note maturity dates which best suit his or her financial condition. As discussed on page 89, we recognize that the Canadian rollover mortgage does not afford the borrower a guarantee that the loan will be refinanced at the time of note renewal; hence, the borrower has no assurance of a 30-year mortgage commitment.

Our observations on the borrower option did not envision that this process would be open to negotiation; rather, at each note renewal date, lenders might make available to borrowers various alternative note maturity dates at various interest rates. The interest rates would reflect the lender's cost and risk factors.

Regarding our recommendation that interest rate cap structures be studied with a view toward standardization, FHLBB indicated that it is necessary to balance the lender's need to increase interest rates with the borrower's ability to handle the increased payments. FHLBB also indicated that severe limitations on the lenders' ability to raise rates, particularly when coupled with unrestricted rate decreases, would likely make the instrument unworkable. FHLBB indicated further that giving the lender an unlimited ability to raise interest rates could create severe problems for both borrowers and lenders--the possibility of unlimited rate increases might make underwriting of these loans more difficult and default risks might increase.

We agree that adjustable rate mortgages need sufficient flexibility so that they will be attractive to lenders and investors. Our analysis of homeowners' incomes coupled with FHLBB's lack of empirical data for establishing the caps led us to recommend that studies were needed to show the effects of the interest rate cap structures on various income groups. Accordingly, we believe that emperical data is needed to establish fair and equitable interest rate structures which give consideration to both borrowers' and lenders' needs.

FHLBB also stated that our report implied that the downside cap on interest rates should be eliminated. We did not recommend that downside caps be eliminated. Rather, our recommendation envisions that any study of the interest rate cap structures would include both upside and downside interest rate adjustments. Adjustments on either of these caps would necessarily affect both borrowers and lenders.

FHLBB indicated that it is urgent that savings and loan associations be given maximum flexibility regarding originating adjustable rate mortgage loans without unreasonable constraints that will act as a deterrent to providing affordable mortgage credit to the Nation. We do not view our observations on the various AMIs authorized by the FHLBB as unreasonable constraints on the lending industry. It was our aim that the Federal regulators might benefit from closer coordination of their respective efforts to design and authorize adjustable rate mortgages. This action would serve to produce improved mortgage instruments through uniform and more comprehensive consumer safeguards, considering both borrowers' and lenders' needs. We believe that such actions are necessary to ensure that home buyers are treated fairly in selecting one of the new AMIs. We believe also that a mechanism is needed to achieve uniformity for purposes of administration, as well as facilitating the role of such mortgages on the secondary market.

Office of the Comptroller of the Currency

OCC stated that because their evaluation of proposed regulations is now underway, it would be premature to comment on the report. (See app. IV.) However, they said they would weigh the issues raised in the draft report as they proceeded to finalize their regulations on ARMs. Also, OCC stated that in early December 1980, FHLBB and OCC jointly sponsored hearings on ARM regulations in Washington, D.C., Chicago, and Los Angeles.

OCC issued its ARM regulations on March 27, 1981. The regulations do not provide for either choice of an SFPM or worst-case disclosure information for the home buyer. Regarding our recommendation that a study should be made to assess the interest rate cap structures with a view toward establishing standardized interest rate caps, OCC has essentially eliminated the caps by providing that the maximum interest rate change may not exceed 1 percentage point for every 6-month period between adjustments. Moreover, the regulations do not address our observation that a study be made to determine whether the borrower should be offered the option of selecting the note maturity dates.

RECOMMENDATIONS

We recommend that the Chairman of the FHLBB and the Comptroller of the Currency develop and administer uniform consumer safeguards in all adjustable rate mortgage regulations These safeguards should

--require that home buyers under all adjustable rate programs be provided a choice between a standard mortgage and the adjustable rate mortgage being offered and

--provide prospective borrowers full disclosure concerning monthly mortgage payment increases and total mortgage payments they potentially face over the life of their mortgage commitment.

In addition, we recommend that the FHLBB determine whether borrowers should be given the option of different note maturity dates than now offered.

Finally, we recommend that the Federal regulators study the interest rate cap structures for the various instruments being offered and applicable risks with a view toward establishing standardized interest rate caps that provide mutual and equitable protection to both consumers and lenders.

CHAPTER 4

IMPROVEMENTS NEEDED IN HUD'S GRADUATED PAYMENT MORTGAGE PROGRAM

Although HUD's section 245(a) graduated payment mortgage (GPM) program has enabled many home buyers to purchase homes which they might not have been able to qualify for otherwise, the following problem areas need management's attention.

--Although a homeowner's monthly mortgage payments increase during the early years of a graduated payment mortgage, HUD underwriters lack the criteria necessary to assess the home buyer's ability to meet these increasing payments.

--GNMA has not yet agreed to accept the 10-year GPM plans for participation in their mortgage-backed securities program, thereby impeding the program's growth.

--Home buyers are selecting primarily one of the five GPM plans available, with indications that some home buyers are not being fully apprised of the other four GPM options.

In addition, section 245(b) which was introduced in June 1980 is considered by HUD officials to be a greater risk than other HUD single-family programs. This program is aimed at broadening the availability of GPM's for low-to-moderate income people. HUD officials indicate the program may experience foreclosure rates between 25 and 50 percent higher than the section 203(b) regular insurance program if the appreciation rate for homes does not remain relatively high.

GOALS AND OBJECTIVES OF SECTION 245(a)

HUD's objective in designing section 245(a) was to develop and promote a new financing method which would meet the needs of potential home buyers priced out of the market. Unlike a level payment mortgage where monthly payments are the same for the the mortgage's duration, the GPM monthly payments start low relative to the level payment mortgage, gradually increase, and then level out. Hence, some families whose incomes might not qualify them for a particular home with a level payment mortgage may be able to qualify for a GPM because of the lower initial monthly payments. HUD expects that incomes will increase sufficiently to accommodate the annual increase in monthly mortgage payments. HUD's GPM

differs from the FHLBB's GPAM mentioned on page 44, in that HUD's program specifies the interest rate applicable for the entire mortgage term, whereas under FHLBB the interest rate can be renegotiated periodically.

The Congress stipulated that the new loans should (1) have promise for expanding housing opportunities or meet special needs, (2) be developed to include any safeguards for purchasers and lenders that may be necessary to offset special risks of such mortgages, and (3) have potential for acceptance in the private market.

Program design

In November 1976, HUD offered five repayment plans to provide home buyers a wide range of choices without the probability of financial strain. Three plans would permit mortgage payments to increase at a rate of 2-1/2, 5, or 7-1/2 percent over the loan's first 5 years, and two plans would permit payments to increase 2 or 3 percent annually over the loan's first 10 years. Starting at the 6th year for the 5-year plans, and the 11th year for the 10-year plans, the payments would level off for the remaining mortgage term. HUD's analysis of family income changes indicated that families with younger household heads (ages 25 to 44) can typically expect to enjoy more increases in family income than overall median incomes. The rates of these increases suggest a capacity on the part of families to handle an increasing payment obligation in line with the GPM plans.

Section 245(a) is open to anyone who can meet the qualifying requirement with respect to employment and income. The legislation for section 245(a) did not impose limitations on income or age restrictions on home buyers.

The following table compares features of the five GPM plans, including the downpayment and the monthly mortgage payments for a $65,000 home under the GPM plans at 12.5 percent and a section 203(b) level payment mortgage at 12 percent. The interest rates were FHA's statutory rates in effect as of August 1980. As shown, payments in the first year under the GPM range from $472.78 to $598.42 compared to $640.31 under section 203(b). Also, downpayment requirements under GPM range from $3,863 to $7,595, compared to $2,750 under section 203(b).

Comparison of Selected Features Under the Five GPM Plans and the Section 203(b) Level Payment Mortgage

	Section 203(b)	Section 245(a)				
		Plan I	Plan II	Plan III	Plan IV	Plan V
Years payments increase	-	5	5	5	10	10
Increase per year	-	2-1/2%	5%	7.5%	2%	3%
Sales price	$65,000	$65,000	$65,000	$65,000	$65,000	$65,000
Minimum downpayment	$2,750	$3,863	$5,759	$7,595	$5,374	$7,579
Mortgage amount	$62,250	$61,137	$59,241	$57,405	$59,626	$57,421
Monthly payments						
Year						
1	$640.31	$598.42	$531.85	$472.78	$571.84	$521.40
2	640.31	613.38	558.44	508.23	583.28	537.04
3	640.31	628.72	586.36	546.35	594.95	553.15
4	640.31	644.43	615.68	587.33	606.85	569.74
5	640.31	660.54	646.46	631.38	618.98	586.84
6	640.31	677.06	678.79	678.73	631.36	604.44
7	640.31	677.06	678.79	678.73	643.99	622.57
8	640.31	677.06	678.79	678.73	656.87	641.25
9	640.31	677.06	678.79	678.73	670.01	660.49
10	640.31	677.06	678.79	678.73	683.41	680.30
11-30	640.31	677.06	678.79	678.73	697.07	700.31
Total interest	$168,262	$178,614	$176,648	$174,323	$180,188	$177,645

A unique feature of the GPM program is negative amortization, which occurs when the initial monthly mortgage payments do not fully cover the interest and principal necessary to amortize the loan. The difference or shortfall is added to the principal, increasing the loan balance. According to HUD, the legislation requires future, unpaid interest to be treated as principal for the loan-to-value restrictions at the loan's inception. This causes the downpayment under section 245(a) to be higher than under section 203(b) in order to maintain the appropriate ratio.

The following table demonstrates how the loan balance for a GPM increases in early years, as compared to the standard level section 203(b) mortgage.

Comparison of Principal Amortization for Section 203(b) and Section 245(a) Plan III Loans First 6 Years

	Section 203(b)	Section 245(a) plan III
Home price	$65,000	$65,000
Downpayment	2,750	7,595
Beginning principal	62,250	57,405
1st year	62,024	58,996
2d year	61,770	60,348
3d year	61,483	61,394
4th year	61,160	62,057
5th year	60,795	62,249
6th year	60,385	61,863

NEED TO STRENGTHEN THE UNDERWRITING CRITERIA

GPM loans may contain greater risks than regular mortgage loans. These risks exist because negative amortization results in lowering the equity accumulation while increasing the loan balance and because monthly payments increase in the GPM's early years. Although section 245(a) appears riskier than section 203(b), HUD underwriters are using the same underwriting criteria to assess home buyers income under both programs. GPM guidelines direct HUD underwriters to reasonably assure themselves that the home buyer's income will increase sufficiently to accommodate mortgage payment increases. However, there are no specific instructions on exactly how this should be accomplished.

Program features make GPMs riskier

Negative amortization and increasing payments in the mortgage's early years increase the risk of default because of the low amount of equity accumulated during the first years of the GPM loan and the need for the home buyer's income to increase to cover the increasing monthly payments. As shown on page 56, during GPM's initial years, for plan III, the payments start at $473 a month and increase to $679 a month in the 6th year.

The equity-to-value ratio at any point in time, including the (1) original equity (downpayment), (2) equity accumulated through mortgage payments, and (3) equity acquired through property appreciation is logically expected to influence default risk. The less equity borrowers have tied up in their property the less will be their financial loss through foreclosure, and the greater their financial incentive to default.

A number of studies 1/ in the 1970s have identified certain loan, borrower, and property characteristics which appear to correlate with loan delinquency and foreclosures. These studies indicate that the strongest predictor of default is the loan-to-value ratio, or the amount of money invested in the property.

According to two of the studies, default losses appear to be especially sensitive to low rates of appreciation. Because equity accumulation appears to be the dominant factor in determining risk of default, in those situations in which equity is reduced due to lower property values or negative amortization, larger default risk increases occur especially in the case of GPMs.

Another feature which adds a certain amount of risk to the GPM is the problem underwriters have in assuring themselves of future income potential of GPM applicants. The underwriting standards for the GPM program are similar to other HUD single-family insurance programs, with the exception of the provision for projecting future income potential. This requirement suggests that HUD underwriters be reasonably assured the home buyer has prospects for income increases which approximate the graduated mortgage payment increases. In reality, however, underwriters are approving GPM loans on the same basis as section 203(b)--on current and past income/expense information. As a result, several underwriters told us they felt discomfort with the ambiguous guidelines.

HUD underwriters use a set of predetermined standards, as well as their own judgment, in assessing the acceptability of a homeowner as a credit risk. The mortgage credit analysis determines the credit risk of insured mortgages and

---

1/J. Follain and R. Struyk, "Homeownership Effects of Alternative Mortgage Instruments," Urban Institute, June 1977; Kerry Vandall, "Single Family Defaults and Foreclosures," HUD, 1975; "Default Risk Under Alternative Mortgage Instruments," Journal of Finance, Dec. 1978.

minimizes the probability of foreclosures or collection difficulties. The entire credit risk analysis is based upon the relationship of the home buyer's credit, assets, income stability, adequacy of effective income for total obligations, and other elements. The mortgage risk analysis involves determining whether the critical elements of the transaction may contribute to loan delinquencies or foreclosures. HUD underwriters, unable to determine how to accurately forecast income potential, said they basically follow section 203(b) guidelines when processing applications.

Two internal HUD studies have pointed out the need for improved criteria for section 245(a). In one study, issued in November 1977, a HUD director of underwriting analyzed 83 GPM cases and concluded the problem of program risk is exacerbated because there were no specific underwriting instructions for determining upward mobility. The other study, conducted by HUD's Inspector General in September 1979, also concluded that HUD should devise guidelines for underwriters to use in evaluating a purchaser's income potential. HUD's Inspector General found no analysis of future income potential was being done and that lenders and underwriters were determining only that the applicant was qualified based on the first year's income and monthly mortgage payment.

HUD underwriters vary somewhat in how they assure themselves of a borrower's capability to meet rising mortgage payments. One area of dissimilarity involves how they forecast income increases. Four supervisors said they assume most everyone receives cost-of-living increases which would normally accommodate mortgage payment increases. Two supervisors kept a job file which tracks wages and cost-of-living information so they could readily determine if the home buyer's job has promise of increased income. One HUD supervisor requests the employer to comment on the buyer's income potential if the expense to income is close.

Another difference we noted among the practices followed by underwriters involved how they viewed people on fixed incomes. Fixed income generally includes payments from welfare, aid to dependent children, social security, and fixed annuities. While two of the HUD supervisors indicated that they would question and probably deny loans to people on fixed incomes, two others indicated they had no objections in accepting that kind of income when approving a GPM application.

THE SECONDARY MORTGAGE MARKET PROBLEMS WITH THE GPM HAVE IMPEDED ITS GROWTH AND INCREASED ITS COST

One of the major impediments faced by the GPM program is its problems in the secondary mortgage market. One of the conditions the Congress established in its authorizing legislation of 1974 was that section 245 loans "have a potential for acceptance in the private market." However, GNMA's delay in accepting GPMs as part of their mortgage-backed securities (MBS) program, and its refusal to purchase 10-year plans has slowed the GPM's acceptance. Many lenders use GNMA's MBS program as a means of pooling their mortgages and selling the securities to obtain funds for making new loans.

GNMA policies inhibit GPM use

GNMA's delay in accepting GPMs as part of their MBS 1/ program and their refusal to approve 10-year plans for the program has impeded the growth of section 245(a). GNMA did not establish a MBS program for 5-year plans until April 23, 1979, a full 2-1/2 years after section 245(a) was implemented. Moreover, as of December 1980, GNMA has still not approved for participation 10-year plans in the MBS program.

In an October 15, 1976, memorandum to the Deputy Assistant Secretary for Policy Development, HUD, the President of GNMA explained why there would be problems including GPMs in the MBS program. He also said that a new type of single-family security with both level payment mortgages and varying types of GPMs was being designed. Further, he said that the mix of mortgages would be necessary to offset the problems of pooling too few GPMs and the affect of negative amortization. Moreover, he said they expected the new program to be operational within 2 to 4 months.

In a May 25, 1977, memorandum more than 7 months later, the Assistant Secretary for Housing asked GNMA's President why it was taking so long for GNMA to study the feasibility of including GPM loans in the MBS pools. The Assistant Secretary said this inclusion would give lenders flexibility and was critical in the ultimate success of the program. In

---

1/MBS provides for the pooling of loans that are homogeneous with respect to interest rate and term of maturities. GNMA guarantees the timely payment of principal and interest on securities issued by approved private lenders. These securities are backed by federally insured or guaranteed mortgage loans.

a June 3, 1977, memorandum, GNMA's President said that extensive analysis had showed two issues were holding up the problem's resolution. He said the idea of combining nonhomogeneous loans seriously complicates the administration of the pools and could affect their marketability. The other question he raised was whether the low volume of GPMs with their varying plans would be in sufficient amounts to assemble the loans in homogeneous pools. GNMA approved the 5-year GPM plans for the MBS program in April 1979. As of October 1980, $3.6 billion in GPMs have been included in the MBS program.

In January 1980, the Assistant to the Vice-President of GNMA/MBS said the design of the MBS program for GPMs was delayed because it had a low priority. He said the late 1977 implementation date for the GPM program and the low level of activity extended the amount of time GNMA took to develop the program. Regarding the 10-year plans, he said there plans were not included in the GPM/MBS program because of investor reluctance to get involved with an instrument where the principal balance increases through the 8th or 9th year. The extended negative amortization along with the assumed 12 year prepayment of the mortgages caused investors too much concern over pricing.

FNMA has purchased all GPM plans but at a lower price. Because of the higher costs, many lenders told us that they are reluctant to offer any GPMs unless they are able to use MBS. Prior to the start of GNMA's MBS program for the graduated payment mortgages in April 1979, FNMA purchased most of the section 245(a) loans. A FNMA official said that they adjust the price they pay an originator for a GPM to compensate for decreased cash flow. FNMA charges higher discount points for GPM loans than does GNMA. The 10-year GPMs are discounted more than their 5-year counterparts.

Investor problems with the GPM increases its cost

GPMs pose certain types of problems for financial institutions and investors. These problems, which make investors averse to purchasing section 245(a) loans, include nonstandard cash flow problems and taxation problems. Lenders have been demanding larger discounts on GPMs compared with level-payment mortgages.

Recently HUD recognized the higher GPM costs by announcing that lenders would be allowed to charge a higher nominal interest rate for GPMs than for their other FHA mortgages. Effective November 21, 1980, the maximum rate

for a section 245(a) mortgage was 14 percent or 1/2 percent higher than for other HUD single-family loans.

Negative amortization reduces cash flow in a GPM's early years as compared with the SFPM. The lower cash flow also decreases the volume of funds available to investors for additional lending.

According to a 1977 Internal Revenue Service ruling (77-135, 1977-1 C.B. 133) on HUD's GPM program, the treatment of interest for tax purposes depends upon whether the taxpayer is using the accrual or cash method of accounting. For the accrual investor, interest income is recognized in the taxable year it is earned, regardless of the year it is collected. The cash basis investor recognizes interest income in the taxable year in which it is actually received. Consequently, lenders using the accrual method will probably view the GPM as less advantageous. In the early years, they will have to pay taxes on income they have not received, and though this will be balanced by lower reportable income in the future, it is generally recognized that dollars received in the future are worth less than dollars received earlier.

HOME BUYERS ARE NOT USING ALL GPM PLANS

Although HUD offers five GPM plans under section 245(a), plan III is used more often. The five plans were developed to provide home buyers the means to tailor their mortgage payments to their present and anticipated income. However, most lenders, realtors, and HUD officials told us that plan III is used a majority of the time because it provides the lowest initial monthly payment and it allows buyers to purchase larger homes than any of the other four plans.

The following chart shows plan III was used 85.6 percent of the time in calendar year 1979.

Comparison of Plans for GPMs Written in 1979

Plan	Number	Percent
I	4,877	6.0
II	6,120	7.5
III	69,491	85.6
IV	678	0.8
V	45	0.1
Total	81,211	100

In our talks with realtors and lenders, we asked why plan III was used more often. Realtors, who normally introduce the GPM concept to buyers, generally agreed they do not discuss all five plans because they believe it would confuse the home buyer. A majority of realtors said they suggest plan III more often because it gives home buyers more for their money. Some realtors indicated plan III was the only plan they were familiar with.

Most lenders said they basically leave the GPM plan selection to the realtors and are reluctant to change any sales agreement for fear of ruining the negotiations. Only 4 of the 32 lenders we contacted indicated they routinely explain all five GPM plans to buyers and what options are available.

While HUD requires a disclosure statement to inform home buyers of their increasing GPM payments, there is no requirement that home buyers be made aware of all five GPM payment plan options. Several HUD underwriting supervisors told us that they were aware consumers are not informed of all plans when applying for a GPM. In January 1979, HUD's Region IX issued a study entitled, "An Early Evaluation of HUD's Graduated Payment Mortgage Program." The study indicated the popularity of plan III is not only due to a consumer decision to lower monthly payments as much as possible, but also to the failure of realtors and lenders to inform consumers of all the options available. According to the study, lenders and realtors feel it will take too much time to explain all the rather complicated plans to relatively unsophisticated buyers. Further, the study indicated that for some lenders, developing five programs to produce tables of future payment obligations is a burdensome expense. Several lenders suggested that consideration should be given to limiting the available options to two or three GPM plans that provide a great deal of variety.

Since the full intent of offering mortgage options to meet consumers' needs has never been realized, the HUD study concluded that HUD reconsider the number of plans available and limit the GPM choices to two plans, specifically plans III and IV. HUD headquarters response in March 1979 to the recommendation was that there was insufficient program experience to determine that any of the plans be discontinued at that time.

WHO IS BEING SERVED BY SECTION 245(a)?

Section 245(a) is serving a population very similar to the population being served by HUD's section 203(b) level payment mortgage insurance program. For example, the average age of a GPM home buyer is 30, while it is 31 for a home buyer obtaining a 203(b) mortgage. The monthly income for both groups is also comparable, $2,014 for a section 203(b) purchaser and $1,930 for a 245(a) purchaser. The housing expense to income ratio was also similar, 26.9 and 25.8, respectively, for new and existing homes for section 203(b) and 26.9 and 27.1, respectively, for new and existing homes under section 245(a). The greatest difference between the two programs is the price of the homes, with GPM buyers paying approximately $13,000 more for an existing home and $5,000 more for a new home than their section 203(b) counterparts.

Consequently, many people who may not have needed GPMs to purchase a home may have used GPM to enable them to buy more expensive homes. A December 1979 HUD interim evaluation of the GPM program stated the congressional intent to expand homeownership opportunities was being fulfilled under the GPM program. The study's findings showed that a large majority of users were young, first-time home buyers. However, another finding indicated over 40 percent of all section 245(a) home buyers could have qualified for the same or a larger mortgage under section 203(b).

Table 1 provides a comparison of key home purchase characteristics for all mortgage loans insured in calendar year 1979 under HUD's section 245(a) with section 203(b). Although we were able to partially explain some of the differences between the home purchase characteristics under the two programs, a full explanation of the differences would require substantial additional effort which was beyond the scope of our review.

TABLE 1

Comparison of Key Home Purchase Characteristics
of Section 203(b) and Section 245(a) Mortgages Insured in 1979

Home purchaser characteristics (note a)	Section 203(b)		Section 245(a)	
	New home	Existing home	New home	Existing home
Home buyers' monthly income	$ 2,266	$ 1,964	$ 2,030	$ 1,904
Home price	$48,216	$37,734	$53,080	$51,056
Downpayment	$ 4,032	$ 2,354	$ 5,383	$ 5,081
Mortgage amount	$44,584	$36,326	$47,744	$46,011
Home size (square feet)	1,336	1,208	1,359	1,270
Number of rooms	5.7	5.6	6.0	5.7
Age of mortgagor	31	31	30	30
Housing expense to income ratio	26.9	25.8	26.9	27.1
Fixed expense to income ratio	44.2	43.2	43.9	44.0
Percent distribution of homes	8.9	91.1	14.6	85.4

a/All characteristics are expressed in averages.

Home buyers' monthly income

Incomes for the section 203(b) buyers do not vary significantly from those of the section 245(a) buyers' income level as shown in table 2. The greatest variance occurs in the income bracket over $2,400 per month, where 16.9 percent of the section 245(a) buyers exceed that amount compared to 21.9 percent of the section 203(b) buyers.

TABLE 2

Distribution of Home Buyers' Monthly Income

Income (monthly)	Section 203(b)		Section 245(a)	
	New home	Existing home	New home	Existing home
	(Percent)			
Under $1,000	0.0	3.2	0.1	2.0
$1,000 to $1,199	0.2	5.8	0.4	5.0
$1,200 to $1,399	0.5	9.5	1.1	9.2
$1,400 to $1,599	0.8	12.1	1.9	12.7
$1,600 to $1,799	1.0	12.5	2.3	13.8
$1,800 to $1,999	1.2	11.4	2.2	12.1
$2,000 to $2,199	1.2	10.2	2.1	9.9
$2,200 to $2,399	1.0	7.5	1.5	6.9
Over $2,400	2.9	19.0	3.0	13.9
Total (note a)	8.9	91.1	14.6	85.4

a/Does not add due to rounding.

Home price

As shown in table 3 on page 66, the homes purchased under section 245(a) averaged $12,100 more than the homes purchased under section 203(b). These figures represent national averages and include both existing and new homes for the two HUD programs. About 70 percent of the home buyers under section 203(b) purchased homes costing $45,000 or less, whereas 71 percent purchased homes costing more than $45,000 under section 245(a).

TABLE 3

Distribution of Home Purchase Price

Price range	Section 203(b)		Section 245(a)	
	New home	Existing home	New home	Existing home
	(Percent)			
Under $35,000	0.8	40.8	0.3	8.6
$35,001 to $40,000	1.3	15.0	0.9	9.0
$40,001 to $45,000	1.6	10.7	1.9	11.3
$45,001 to $50,000	1.5	8.2	2.9	12.6
$50,001 to $55,000	1.3	5.9	2.8	11.9
$55,001 to $60,000	1.1	5.1	2.3	11.6
$60,001 to $65,000	0.7	3.2	1.8	10.4
$65,001 to $70,000	0.3	1.2	1.1	5.9
Over $70,000	0.2	0.9	0.6	4.2
Total (note a)	8.9	91.1	14.6	85.4

a/Does not add due to rounding.

Downpayment

As shown in table 4 on page 67, there are substantial differences in the downpayments made under the two programs. As discussed on page 55, section 245(a) requires a higher downpayment to accommodate the negative amortization which accrues during the early years when low monthly mortgage payments are required. Our analysis shows that 50 percent of the home buyers under section 203(b) made downpayments of less than $1,000, whereas 64 percent made downpayments of $3,001 or more under section 245(a).

TABLE 4

Distribution of Cash Downpayment

Price range	Section 203(b)		Section 245(a)	
	New home	Existing home	New home	Existing home
	(Percent)			
Under $1,000	2.5	47.9	0.5	3.9
$1,001 to $2,000	2.8	22.3	1.1	9.4
$2,001 to $3,000	0.8	6.0	2.5	18.4
$3,001 to $4,000	0.4	3.5	3.8	20.5
$4,001 to $5,000	0.4	3.0	2.1	10.4
$5,001 to $7,000	0.5	2.8	1.8	7.2
$7,001 to $9,000	0.4	1.6	0.8	4.4
Over $9,000	1.1	4.1	2.0	11.2
Total (note a)	8.9	91.1	14.6	85.4

a/Does not add due to rounding.

Mortgage amount

As shown in table 5 on page 68, over 22 percent of the section 245(a) home buyers obtained mortgages in the $55,001 to $60,000 range compared with only 8.5 percent in section 203(b). Also, 47 percent of the home buyers in section 203(b) obtained mortgages amounting to less than $35,000 compared with only 13.8 percent in section 245(a).

TABLE 5

Distribution of Mortgage Amount

Mortgage amount	Section 203(b)		Section 245(a)	
	New home	Existing home	New home	Existing home
	(Percent)			
Under $35,000	1.4	45.2	0.7	13.1
$35,000 to $40,000	1.7	14.3	1.8	11.8
$40,001 to $45,000	1.6	10.9	3.0	14.5
$45,001 to $50,000	1.5	7.9	3.3	13.8
$50,001 to $55,000	1.2	5.8	2.6	12.7
$55,001 to $60,000	1.4	7.1	3.0	19.4
Total (note a)	8.9	91.1	14.6	85.4

a/Does not add due to rounding.

Home size

As shown in table 6 on page 69, our analysis of the homes in terms of square feet of improved living space showed that there was very little difference between the two HUD programs. Homes purchased under section 203(b) averaged 1,233 square feet compared with 1,294 square feet for those purchased under section 245(a), or a difference of 61 square feet.

TABLE 6

Distribution of Homes by Square Feet

Range	Section 203(b)		Section 245(a)	
	New home	Existing home	New home	Existing home
(square feet)	(Percent)			
Under 1,000	0.9	25.7	1.3	16.1
1,000 to 1,099	1.1	13.3	1.4	12.1
1,100 to 1,199	1.1	11.6	2.0	11.7
1,200 to 1,299	1.3	10.6	1.8	11.1
1,300 to 1,399	1.1	8.0	2.1	9.0
1,400 to 1,499	1.2	6.4	1.8	7.2
1,500 to 1,599	0.8	4.7	1.6	5.7
1,600 to 1,699	0.6	3.5	0.9	4.1
1,700 to 1,799	0.3	2.4	0.6	2.9
Over 1,800	0.6	5.0	1.1	5.4
Total (note a)	8.9	91.1	14.6	85.4

a/Does not add due to rounding.

Number of rooms

As shown in table 7 on page 70, over 70 percent of the homes purchased had 5 to 6 rooms under both programs.

TABLE 7

Distribution of Homes by Number of Rooms

Range (rooms)	Section 203(b)		Section 245(a)	
	New home	Existing home	New home	Existing home
	(Percent)			
3	0.0	0.4	0.0	0.1
4	0.6	11.1	0.7	7.3
5	3.5	34.5	4.0	30.7
6	3.3	29.9	6.0	30.6
7	1.1	11.0	2.8	12.6
8	0.3	3.2	0.9	3.5
9	0.1	0.7	0.1	0.5
10 or more	0.0	0.3	0.0	0.1
Total (note a)	8.9	91.1	14.6	85.4

a/Does not add due to rounding.

Age of home buyer

As shown in table 8 on page 71, over one-half of the home purchasers in both programs were under 30 years of age. Also, section 203(b) had more individuals 40 years and older than section 245(a), 15.2 percent and 9 percent, respectively.

TABLE 8

Distribution of Age of Mortgagor

Range	Section 203(b)		Section 245(a)	
	New home	Existing home	New home	Existing home
(years)	(Percent)			
Less than 25	2.1	23.9	3.5	19.8
25 to 29	3.0	28.6	5.5	30.9
30 to 34	1.6	15.7	3.1	18.5
35 to 39	0.8	9.0	1.3	8.6
40 to 44	0.5	5.6	0.5	3.8
45 to 49	0.3	3.5	0.3	1.8
50 to 60	0.4	3.9	0.3	1.8
Over 60	0.1	0.9	0.1	0.3
Total (note a)	8.9	91.1	14.6	85.4

a/Does not add due to rounding.

Percent of income spent on housing and fixed expenses

For many years lending institutions have followed a rule of thumb which assumed that home buyers should not devote more than 25 percent of their income to housing expense without risking financial difficulty. A 1980 report by the United States League of Savings Associations entitled, "Coping with Inflation," concluded that home buyers stretched their budget further than ever in 1979. The report concluded that nearly 46 percent of all home buyers in 1979 incurred total monthly housing expenses which exceeded 25 percent of their income. On the other hand, HUD expense to income guidelines for section 245(a) allow housing expenses to go as high as 35 percent and total fixed expenses to go as high as 50 percent of effective income.

Our analysis shows that 63 percent of the home buyers in the section 245(a) program spent 25 percent or more of their income on housing expenses compared with 55 percent under the section 203(b) program.

TABLE 9

Distribution of Housing Expense to Income

Range	Section 203(b)	Section 245(a)
(percent)	(Percent)	
Under 20	18.5	13.0
20 to 24	26.3	24.0
25 to 29	28.5	30.6
30 to 34	18.7	22.8
35 to 39	6.2	7.6
40 to 44	1.5	1.7
45 and over	0.3	0.3
Total	100	100

HUD underwriters use the 35/50 guideline, a standard HUD benchmark, to determine if a buyer has sufficient income to afford the home. Several HUD underwriting supervisors we visited felt it is important to keep the ratio of income to expenses at a low level because the increasing mortgage payments would create too much of a strain if the initial expenses were already high. Most supervisors said they have to review and approve any cases where the total 35/50 guidelines are exceeded. Two other supervisors said they have allowed the fixed expense ratio to exceed 70 percent when the documentation on the application warranted it. As shown, however, national statistics for section 203(b) and 245(a) indicate little difference in the ratios of fixed expenses to effective income. Most home buyers' fixed expenses fall into the 35 to 60 percent range, with few above 60 percent.

TABLE 10

Distribution of Fixed Expenses to Effective Income

Range	Section 203(b)	Section 245(a)
(percent)	----------Percent----------	
Under 20	0.3	0.2
20 to 24	1.0	0.4
25 to 29	3.6	2.2
30 to 34	9.9	8.0
35 to 39	19.0	18.5
40 to 44	25.1	27.0
45 to 49	21.5	23.4
50 to 54	12.3	13.0
55 to 59	5.0	5.0
60 to 64	1.5	1.5
65 to 69	0.4	0.4
70 to 74	0.1	0.1
75 to 79	0.1	0.2
Total (note a)	100	100

a/Does not add due to rounding.

Other mortgage characteristics

We used other factors to analyze mortgage purchase activities; for example, race of home buyers and neighborhood location. Also, the bulk of the homes insured under section 203(b) were in urban areas, while a majority of those in section 245(a) were in the suburbs and rural areas.

Race of homeowners

As shown in table 11 on page 74, minorities represented about 17 percent of the home buyers in section 245 compared with 24 percent in section 203(b). Blacks accounted for 5.4 percent use under the GPM program compared with 13.7 percent under the 203(b) program. Three realtors said minorities--particularly blacks--found it difficult to obtain GPM loans because they often did not have the larger downpayment needed for section 245(a).

TABLE 11

Distribution of Race of Home Buyers

Race	Section 203(b)		Section 245(a)	
	New home	Existing home	New home	Existing home
	Percent			
White	7.4	69.1	12.3	70.5
Negro-Black	0.6	13.1	0.6	4.8
American Indian	0.0	0.2	0.0	0.2
Oriental	0.2	0.8	0.5	1.0
Spanish American	0.5	7.0	0.8	7.7
Other minority	0.2	0.9	0.4	1.2
Total	8.9	91.1	14.6	85.4

Neighborhood location

As shown in table 12, section 245(a) is more heavily concentrated in the suburban areas than section 203(b), 46 percent compared with 34 percent, respectively.

TABlE 12

Distribution of Homes by Neighborhood

Location	Section 203(b)	Section 245(a)
	Percent	
Core city (note a)	1.8	.8
Other city	49.6	38.7
Suburban	34.1	46.1
Rural	2.7	1.6
Missing data	11.8	12.8
Total	100	100

a/An area comprising the deteriorating downtown or old town portions of a city.

POTENTIAL PROBLEMS WITH HUD's NEW SECTION 245(b)

HUD's new section 245(b) program faces potential problems with defaults which may adversely affect its financial integrity. HUD officials recognize the unique nature of the program and plan to closely monitor the actual losses to determine if it exceeds reasonable expectations. The new section 245(b) was authorized by the Congress in December 1979 as part of the Community and Neighborhood Development and Conservation Act (Public Law 96-153).

The goals and objectives of section 245(b)

The purpose of section 245(b) is to broaden the availability of GPMs for low- to moderate-income people, particularly the young who do not earn enough money to qualify for other home loans, and also to help stimulate and stabilize housing production. The program is targeted to moderate-income families who are buying their first homes. The amendment does not alter the existing section 245(a) program.

The new program is limited to applicants who could not reasonably afford to purchase a home by using the existing HUD programs. Also, the program is only available to buyers who have not owned a home in the past 3 years. Section 245(b) requires a smaller downpayment than section 245(a) because the loan balance is allowed to exceed the original appraisal value by as much as 13 percent, whereas section 245(a) is limited to 97 percent of the appraised value.

FHA insurance authority is limited to 10 percent of the aggregate mortgages on one to four family residences in the previous fiscal year, or 50,000 mortgages, whichever is greater. Also, HUD has restricted program eligibility to new or substantially rehabilitated housing. The section 245(b) buyer has a choice of two GPM plans--one where mortgage payments increase for 10 years at a rate of 4.9 percent a year and another where payments increase for 5 years at a rate of 7-1/2 percent a year.

Unlike HUD's section 245(a) program, section 245(b) underwriting guidelines specify criteria which should be used in forecasting income potential. Underwriters are cautioned not to approve buyers who only receive fixed incomes, unless it can be determined the income will be able to support rising housing payments plus other costs at the time

the GPM reaches the maximum monthly payment. Additionally, the guidelines instruct each mortgage credit branch to develop data on employment trends, future union-negotiated contracts, and the growth by type of industry. Employers are encouraged to include a statement concerning cost-of-living allowances and a review of employee performance and company wage policies. Alsc self-employed individuals are required by HUD to furnish financial statements covering the last two full years prior to applying for the mortgage.

Comparison of sections 245(a) and (b)

The following table compares monthly payments under the two section 245(b) payment plans with monthly payments under plan III of section 245(a).

TABLE 13

Comparison of Monthly Payments Under Section 245(a) and 245(b)

	Section 245(a) Plan III	Section 245(b) Plan I	Section 245(b) Plan II
Years payments increase	5 years	5 years	10 years
Increase per year	7.5%	7.5%	4.9%
Sales price of home	$65,000	$65,000	$65,000
Minimum downpayment	$ 7,595	$ 2,750	$ 2,750
Mortgage amount	$57,405	$62,250	$62,250
Monthly payments			
Year			
1	$472.78	$512.68	$508.41
2	508.23	551.13	533.32
3	546.35	592.46	559.45
4	587.33	636.90	586.87
5	631.38	684.66	615.62
6	678.73	736.01	645.79
7	678.73	736.01	677.43
8	678.73	736.01	710.63
9	678.73	736.01	745.45
10	678.73	736.01	781.97
11-30	678.73	736.01	820.29
Total interest	174,323	189,036	200,713

Concerns raised about section 245(b)'s higher risk

Some HUD officials have expressed concern about the actuarial soundness of the new section 245(b) program. The Director of Financial Management, HUD, in an April 1980 memorandum to the Director of Management Analysis on the proposed section 245(b) regulations, described the new GPM as a great risk and said that it is improbable that this program could be expected to be actuarially sound. He also said that he did not believe it is in the best interest of home buyers or the Government to implement the new GPM because it will encumber many home buyers with excessive debt. Further, he said that many foreclosures might occur when buyers sell

Contents

CHAPTER		Page	
DIGEST		i	1/A6
1	INTRODUCTION	1	1/B4
	Department of Housing and Urban Development	2	1/B5
	Federal Home Loan Bank Board	3	1/B6
	Office of the Comptroller of the Currency	4	1/B7
	Major suppliers of mortgage credit	4	
	Secondary mortgage market	5	1/B8
2	THE CHANGING ENVIRONMENT IN MORTGAGE LENDING	7	1/B10
	Evolution of the standard fixed payment mortgage	7	
	What are AMIs and how will they affect financial institutions?	9	1/B12
3	ADJUSTABLE RATE MORTGAGES NEED BETTER CONSUMER SAFEGUARDS	14	1/C5
	Federal efforts to promote adjustable rate mortgage instruments	15	1/B
	Standardized safeguards and options needed for adjustable rate mortgage instruments	22	1/C13
	Documented choice provision	22	
	Federal adjustable rate mortgages need more comprehensive disclosure requirements	29	1/D6
	Limitations on interest rate caps should be standardized after study	31	1/D8
	Analysis of discretionary income	33	1/D10
	Consumers should have a wider choice in selecting note maturity dates	40	1/E5
	Recent AMI proposals by FHLBB	43	1/E8
	Conclusions	45	1/E10
	Agency comments and our evaluation	46	1/E11
	Recommendations	51	1/F2

CHAPTER		Page	
4	IMPROVEMENTS NEEDED IN HUD's GRADUATED PAYMENT MORTGAGE PROGRAM	53	
	Goals and objectives of section 245(a)	53	1/F4
	Need to strengthen the underwriting criteria	56	1/F7
	The secondary mortgage market problems with the GPM have impeded its growth and increased its cost	59	1/F10
	Home buyers are not using all GPM plans	61	1/F12
	Who is being served by section 245(a)?	63	1/F14
	Potential problems with HUD's new section 245(b)	75	1/G12
	Conclusions	78	2/A3
	Agency comments and our evaluation	79	2/A4
	Recommendations	81	2/A6
5	OBJECTIVES, SCOPE, AND METHODOLOGY	83	2/A8
	Methodology used to determine hypothetical four-person family income and consumption patterns for the period 1970 through 1990	84	2/A9
APPENDIX			
I	Characteristics of Canada's rollover mortgage program	89	2/A14
II	Information on special loans for the elderly; Wisconsin and California experience with AMIs; and creative financing techniques	92	2/B3
III	Letter dated February 27, 1981, from the Chairman, Federal Home Loan Bank Board	99	2/B10
IV	Letter dated February 13, 1981, from the Comptroller of the Currency	105	2/C2
V	Letter dated March 12, 1981, from the Acting Deputy Assistant Secretary for Housing, Department of Housing and Urban Development	107	2/C4

their property and they learn they owe more than when they purchased the home.

A regulatory analysis done by HUD also estimated that the new section 245(b) could have claim rates between 25 and 50 percent higher than section 203(b). The analysis noted that the problem created by negative net equity could become serious if the current value of homes reflects an over-anticipation of the future value of the property due to declining inflation. On the other hand, the analysis concluded there is a possibility that section 245(b) could achieve long-term soundness if the rate of appreciation of homes remains relatively high, at 6 percent or above.

Section 245(b) became effective June 30, 1980. HUD officials realize that section 245(b) may carry more risk, and therefore, plan to closely monitor the program's actual losses.

CONCLUSIONS

HUD's section 245(a) has been successful in assisting many home buyers to purchase homes. Although the program is relatively new, we believe that certain improvements are needed in order for the program to achieve its full potential.

To minimize problems for homeowners and maintain the financial stability of the insurance funds, we believe that HUD underwriters need to assure themselves that a home buyer's salary will increase sufficiently to accommodate the rising mortgage payments before approving the loan for FHA insurance. Hence, HUD needs to provide under section 245(a) better guidance to underwriters for assessing the future incomes of borrowers. These guidelines should be more in line with what HUD requires under its 245(b) program. Also, HUD should resolve the problems which prevent the 10-year GPM plans from being included in GNMA's MBS program.

Because home buyers are not using all five GPM plans, some purchasers may not be matching their financial circumstances with the best plan available. We believe that HUD should insure that borrowers are at least made aware of the various plans available. Because over 2 years have elapsed since HUD looked at the need for all five GPM plans, it may be time to reassess the need for all the plans.

AGENCY COMMENTS AND OUR EVALUATION

HUD disagreed generally with our recommendations to improve its GPM program. (See app. V.)

Regarding the need for underwriting criteria for the section 245(a) program, HUD stated that while the idea has some merit in theory, it could not envision a set of criteria which would not discriminate against some class of buyers on the basis of age, profession, etc. Also, HUD indicated that few employers would be willing to provide the type of assurance that would be necessary as to the borrower's income potential. Further, HUD indicated that the larger downpayments required under the GPM program helps to minimize the risk of default because the purchaser stands to lose more upon foreclosure, and the purchaser's equity may be sufficient to permit recasting the loan or facilitate selling the property to avoid foreclosure.

While HUD indicated that setting such criteria would discriminate against some class of buyers and few employers would be willing to provide assurance of income potential for home buyers, we note, as discussed on page 76, that its procedures applicable to section 245(b) require the mortgagee to include with the request for verification of employment a statement from the employer describing possible promotion opportunities offered, incentive programs available, and opportunities for additional pay increases either through upward mobility programs, mid-level management training programs, or through union contract terms. These HUD instructions state that the benefits offered by the employer should be delineated so that the HUD mortgage credit examiner can be reasonably assured that the applicant will be able to meet the increase in monthly payments. It should also be noted, as discussed on page 58, that HUD underwriters have different views toward people on fixed incomes. Two HUD supervisors told us that they would question and probably deny loans to people on fixed income, while two other supervisors indicated thay had no objections in accepting that kind of income when approving a GPM application.

Also, discussed on page 58, two internal HUD studies have pointed out the need for improved criteria for section 245(a). These studies concluded that the problem of program risk is exacerbated because there were no specific underwriting instructions for determining upward mobility. The need for information on the homeowner's expected future earning capacity is illustrated by the dramatic change in monthly mortgage payments. For instance, a house purchased under plan III, costing $65,000, would have monthly mortgage

payments the first year of $472 and $678 in the 6 year, an increase of $206, or 44 percent. Homeowners with a section 245(a) mortgage and whose income does not keep pace with inflation may be faced with higher mortgage payments than they are able to pay.

To both assure the financial integrity of the section 245(a) program and to assure that HUD field staff apply underwriting criteria in a consistent and impartial manner, we believe that HUD needs to develop underwriting criteria for assessing future income of applicants under the 245(a) program as it has done for the 245(b) program.

We agree that the larger downpayment under section 245(a) is a desirable feature of the program and it affords both the homeowner and HUD some protection in the event of default. However, we believe that the significantly increasing mortgage payments faced by home buyers in future years are sufficient reason for HUD to tighten up its underwriting activities under section 245(a).

HUD indicated that it would be exceedingly disruptive to the MBS program to include loans with increases in monthly payments over a 10-year period. Also, HUD indicated that acceptance of only the 5-year plans was agreed to approximately 2 years ago in meetings that included securities dealers, representatives of investors, securities issuers, and HUD staff. Further, HUD indicated that it is important for investors in the GNMA securities that there be the maximum possible degree of homogeneity among the loans in the various pools. Without homogeneity, HUD indicated that higher interest rates would be required by investors and the higher costs would be passed along to all FHA and Veterans Administration home buyers.

It should be noted that when establishing the present MBS program for the 5-year GPM plans, GNMA had initially raised similar concerns about the feasibility of establishing homogeneous pools of loans. Despite these concerns, the MBS program for the 5-year GPM plans was approved in April 1979. Regarding the higher interest rates, we note that an industry mortgage security report in April 1979 recognized that the GNMA pools of GPMs would have a spread of 1 to 1-1/2 points below the GNMA pools of SFPMs. It is reasonable to assume that these costs are passed along to all home buyers whose mortgages are included in the MBS program. While the 10-year GPM plans might pose technical problems for including them in the MBS program, we believe that HUD should assure participation of the 10-year plans, such as meeting with securities investors to determine whether the 10-year

GPM plans can be made acceptable to the securities investors. In this regard, it should also be noted that the act authorizing section 245(a) required that such loans have potential for acceptance in the secondary mortgage market. (See p. 54.)

Regarding home buyers being made aware of all GPM plans, HUD indicated that it had expended considerable effort to advertise the various options of the program. Also, HUD indicated that lack of consumer interest and lender and realtor reluctance to get involved with all the plans, coupled with secondary market problems, have combined to cause minimal activity under four of the five plans.

We agree HUD has made a concerted effort to promote the GPM program with brochures, television announcements, and briefings around the Nation to mortgage originators and HUD staff. Because one of GPM's goals was to offer home buyers various mortgage payment plans which best matched their financial condition and because mortgage originators and HUD field staff told us that home buyers were not always being apprised of all the plans, we believe that HUD has a responsibility to determine whether, in fact, home buyers are unwilling to choose the various plans offered or whether they are unaware of such plans. We believe that if home buyers are unwilling to select a sufficient quantity of loans from the various plans offered, coupled with the impediments mentioned with the secondary mortgage market, it may be time for HUD to determine whether it makes sense to continue to offer the present variety of GPM plans. We do not view our proposal of apprising home buyers of all plans as a vehicle for forcing realtors, mortgage lenders, or home buyers to select a particular loan plan. We believe such information is needed by HUD to assess whether or not all loan plans should be offered in the future.

RECOMMENDATIONS

To improve HUD's GPM program, the Secretary should:

--Provide HUD underwriters with criteria to assess future income of home buyers applying for a section 245(a) graduated payment mortgage.

--Require that GNMA work with securities dealers, investors, and issuers to assure participation of section 245(a) 10-year plans in the mortgage-backed securities program.

--Assure that home buyers are apprised of all payment plan options available under the GPM program. One way to do this would be a certification signed by the home buyers that they were informed of all options available.

CHAPTER 5

OBJECTIVES, SCOPE, AND METHODOLOGY

This report examines the issues emerging with the introduction of AMI's by Federal agencies. Our overall objective was to explain how the various AMI's work, and their impact on home buyers, and determine how they can be improved.

We discussed adjustable rate mortgages with officials at OCC and FHLBB headquarters in Washington, D.C., and at FHLBB's Region XI in San Francisco. Region XI was selected because of the early authorization for variable rate mortgages in California. We also contacted FHLBB economists in all regions. In addition, we discussed the secondary mortgage market activities with officials at FNMA and GNMA in Washington, D.C.

We discussed AMI activity at State-chartered thrift institutions with State officials and savings and loan officials in the States of California and Wisconsin. We also contacted State officials in Ohio, Washington, Oregon, Arizona, and Hawaii to ask about AMI activity in those States. We selected the above States because our research showed them to be some of the most active in issuing AMI's. We discussed the Canadian rollover mortgage with officials of the Canada Mortgage and Housing Corporation, Canada's counterpart to FHA, and several Canadian lending institution officials in Ottawa and Toronto.

We discussed HUD's sections 245(a) and (b) programs with HUD officials in Washington, D.C.; its regional offices in San Francisco, Chicago and Atlanta; its area offices in San Francisco, Los Angeles, Chicago, and Atlanta; and at insuring offices in Santa Ana, Sacramento, Columbus, and Birmingham. In each region, we also discussed the programs with mortgage bankers, realtors, and developers. We visited the Chicago, San Francisco, and Atlanta regions because they had processed more than two-thirds of the GPM applications received as of February 1980.

Further, we hired Craig E. Swan, Associate Professor of Economics, University of Minnesota, Ph.D, 1970 Yale University, to review and comment on the matters discussed in this report.

Our comparison of mortgagors in HUD's sections 245(a) and 203(b) programs was based on analysis of the total characteristic file populations of both programs in fiscal year 1979. Section 203 (b) was selected because it is HUD's

standard level payment mortgage program, and section 245 program was set up as an alternative to it.

METHODOLOGY USED TO DETERMINE HYPOTHETICAL FOUR-PERSON FAMILY INCOME AND CONSUMPTION PATTERNS FOR THE PERIOD 1970 THROUGH 1990

Our objective was to determine how adjustable rate mortgages, using different annual and overall interest rate increases, would affect a hypothetical family's discretionary income. To do this, it was necessary to develop income and consumption patterns for the hypothetical family that purchased a home in 1970 and 1980.

Many researchers argue that there is not a typical family with typical income and consumption patterns. However, in social science research, such standard families are needed to limit and/or allow certain types of questions to be studied.

We wanted to examine the ability of a family to meet increases in monthly mortgage payments over time and to assess the impact on their living standard. For our standard family, we used the Bureau of Labor Statistics' Urban Family Budget as the base.

These budgets contain estimates for three hypothetical urban family budgets. The budgets are for (1) lower income budgets, (2) intermediate income budgets, and (3) higher income level budgets--four-person households. The members are an employed husband, age 38, who has a wife not employed and two children.

We selected the intermediate family budget for analysis because the expenditure pattern for this group approximates the spending pattern for median income Americans. The Bureau takes great care to point out that

> "The four-person family budget cost estimates do not represent what a typical or representative American four-person family purchases or earns. Rather, the figures represent the assumptions made about the manner of living--a market basket of goods and services in the urban United States."

We obtained the intermediate budget for the years 1970-78, including the mortgage principal and interest payments. From the 1970 Bureau budget, we removed its principal and interest payment for homeownership. We replaced this figure with the principal and interest cost for an average priced

new home purchased in 1970 at the then prevailing interest rate. We then assumed this to represent a four-person family, 1970 consumption pattern.

To determine an income figure for this family, we added personal savings. We used the 1970 personal savings rate of 7.4 percent as developed by the Bureau.

TABLE 14

Computation of a Hypothetical Four-Person Family's Consumption and Income for 1970

1970-Bureau of Labor Statistics intermediate budget	$10,281
Less: principal and interest payments	1,016
	9,265
Add: GAO calculated principal and interest payments	2,626
Total 1970 consumption	11,891
Add: personal saving at 7.4 percent	950
Computed 1970 family income	$12,841

To increase the $12,841 base for future periods, we used two indexes. The first index, for the period 1970-78, was the observed change in the median income for all four-person families, as reported by the Bureau. For the period 1979-90, we used the Data Resource's spring 1980 U.S. long-term projected (Trendlong 0380) annual rate of change for personal income. This procedure gave us the family income as shown in table 15 on page 86.

For consumption figures, the process was much the same. For the period 1970-79, we used the increase in the Bureau's intermediate four-person family budget, minus the mortgage principal and interest component for their home. For the period 1980-90, we used Data Resource's spring 1980 (Trendlong 0380) personal consumption expenditure projections to increase the consumption figures. (See tables 16 and 17 on pp. 87 and 88.)

To determine income available for mortgage payments and discretionary purposes, we subtracted consumption from family

income. By using this figure, we determined what impact different mortgage instruments' costs would have on the discretionary income available to our hypothetical family. (See table 17 on p. 88.)

Table 15

Percent of Increases in Four-Person Family Income for Period 1970 Through 1990

Year	Percentage increase	Four-person family income
1970	-	$12,841
1971	4.14	13,373
1972	10.17	14,733
1973	7.04	15,770
1974	7.56	16,962
1975	10.26	18,702
1976	6.49	19,916
1977	8.13	21,535
1978	9.11	23,497
1979	12.01	26,319
1980	10.90	29,188
1981	11.75	32,618
1982	13.13	36,901
1983	12.28	41,432
1984	11.29	46,110
1985	11.45	51,390
1986	11.73	57,418
1987	11.68	64,124
1988	10.86	71,088
1989	10.44	78,510
1990	10.42	86,691

TABLE 16

Percentage of Increases in Four-Person Family Consumption for Period 1970 Through 1990

Year	Percentage increase	Four-person family consumption (note a)
1970	-	$ 9,265
1971	7.44	9,955
1972	5.87	10,539
1973	11.04	11,703
1974	13.84	13,322
1975	6.49	14,186
1976	5.50	14,967
1977	6.10	15,880
1978	9.19	17,340
1979	10.07	19,087
1980	12.27	21,429
1981	11.10	23,808
1982	12.77	26,848
1983	12.13	30,105
1984	11.00	33,417
1985	11.67	37,317
1986	11.48	41,601
1987	11.59	46,423
1988	10.57	51,330
1989	10.24	56,586
1990	10.15	62,329

a/Consumption includes expenditures for food; transportation; clothing; personal and medical care; the average costs of reading, recreation, tobacco products, alcoholic beverages, education, and miscellaneous expenditures; gifts and contributions; life insurance; occupational expenses; social security and disability payments; personal income taxes; and house furnishings and operation. Mortgage principal and interest payments were excluded.

TABLE 17

Income Available to Four-Person Families
for Mortgage Payments and Discretionary Income
1970 Through 1990

Year	Family income	Consumption	Available for discretionary income and mortgage payments
1970	$12,841	$ 9,265	$ 3,576
1971	13,373	9,955	3,418
1972	14,733	10,539	4,194
1973	15,770	11,705	4,065
1974	16,962	13,322	3,640
1975	18,702	14,186	4,516
1976	19,916	14,967	4,949
1977	21,535	15,880	5,655
1978	23,497	17,340	6,157
1979	26,319	19,087	7,232
1980	29,188	21,429	7,759
1981	32,618	23,808	8,810
1982	36,901	26,848	10,053
1983	41,432	30,105	11,327
1984	46,110	33,417	12,693
1985	51,390	37,317	14,073
1986	57,418	41,601	15,817
1987	64,124	46,423	17,701
1988	71,088	51,380	19,708
1989	78,510	56,586	21,924
1990	86,691	62,329	24,362

APPENDIX I

CHARACTERISTICS OF CANADA'S ROLLOVER MORTGAGE PROGRAM

The major difference between a SFPM and the Canadian rollover mortgage is that SFPM is generally amortized over 25 to 35 years, with the interest rate fixed for the entire mortgage term. The Canadian rollover mortgage is also amortized over 25 to 35 years, but the term is written on a 5-year basis or less. At the term's end, the mortgage may be renewed under the same amortization schedule, but at the prevailing interest rate.

In Canada, private lenders and private mortgage insurers started issuing rollover mortgages in the early 1960s. The Canadian Mortgage and Housing Corporation, Canada's counterpart to FHA, began offering Federal mortgage insurance on rollover mortgages in 1969. The move to this type of mortgage was caused by the inflationary economy coupled with volatile mortgage and savings rates. Since mortgage investors were uncertain as to what the future held, they began to limit their product line to 5-year mortgages.

The high interest rates in the 1973-74 period resulted in a 1-year rollover mortgage being developed. The 1-year rate was 11.25 percent, 3/4 percent below the then-current 12-percent rate. Borrowers were able to pay less, and at the end of the year, renew the loan at the then current 5-year rate or 1-year rate. Since that time, 2- through 4-year mortgages have been developed. The longer loan terms generally have higher interest rates.

The Canadian consumer has the choice of taking a 1- through 5-year mortgage. If a consumer feels rates are high, he or she can select a 1-year mortgage, hoping the rates will drop during that period. If the rate is lower at year's end, the consumer can select a term ranging from 1 to 5 years.

Most mortgage funds are raised in Canada by issuing guaranteed investment certificates. The certificates are available for 1-through 5-year terms and pay a fixed rate of interest. With this mechanism, mortgage lenders are able to more closely balance the cost of funds and mortgage yield. Canadian banking officials state that this ability to balance assets and liabilities has enabled them to continue to attract funds, and therefore continue their mortgage lending activity. In June 1980, mortgage interest rates at an institution we visited were 13 percent for all loan terms,

while they were paying depositors between 10-1/2 and 11 percent for guaranteed investment certificates.

Canadian banking officials believe rollover mortgages have worked well in Canada. The instrument has given mortgage lenders the means necessary to match assets and liabilities and borrowers the flexibility to choose among varying short-term instruments. They do not believe mortgage money would be available if SFPMs were the only instrument available to lenders.

Concerning consumer protections and awareness, a Treasury Board official stated consumers are aware of their options and that they learn quickly from experience. He said that the Canadian lenders advertise heavily and are very competitive, and as a result, see no need for a government program to educate the public.

At the time a mortgage contract is signed, the borrower knows what the interest rate is, the monthly payments, and the outstanding principal. The same information is given to the borrower when the note is renewed. Moreover, an official of the Trust Companies Association of Canada said that most Canadian consumers retain a lawyer to help clarify contract terms for them.

There has been some concern raised in Canada because of the current high level of interest rates and the resulting impact on homeowners. Newspaper articles on "the mortgage revolt" and "the mortgage crisis" cite examples of interest rates increasing from 11 to 15-1/2 percent, homeowners trying to unload homes before their mortgages come due for renewal at perhaps 40 percent higher rates, and families facing loss of their homes.

Canadian banking officials do not believe the problem is that serious, and note that real incomes generally grow to offset higher mortgage costs. A report by the housing corporation showed that about 35,000, or 10 percent, of the 350,000 households rolling over mortgages in 1980 will have gross debt service ratio over 30 percent. Those rolling over mortgages first negotiated in 1979 are the hardest hit, facing an average increase of 22.5 percent in their monthly mortgage payment. The average household rolling over a mortgage initially obtained in 1975 will have a lower gross debt service ratio in 1980 than when they first obtained

their mortgage. Those renegotiating a mortgage obtained in 1977 face slightly higher gross debt service ratios than they had originally. The report assumed an average interest rate in the year of mortgage origination, an average increase in household income, and a 14.5-percent mortgage rate at rollover.

Mortgage lending officials and housing corporation officials believe rollover mortgages work in Canada, allowing mortgage lenders to more closely match assets and liabilities, and therefore, make mortgage money available. Although foreclosure rates have risen in the last couple of years, housing corporation officials do not believe it is because of higher mortgage payments. They attributed most of the foreclosures to marriage break-ups and situations where a home had experienced no equity increase and the borrower simply walked away from it. Other factors cited were risks inherent in two government-sponsored programs, increasing unemployment, inflation, and rent controls in the provinces. They said that generally homeowners with equity in their homes will go to great lengths to protect it.

INFORMATION ON SPECIAL LOANS FOR THE ELDERLY; WISCONSIN AND CALIFORNIA EXPERIENCE WITH AMIs; AND CREATIVE FINANCING TECHNIQUES

SPECIAL TYPES OF MORTGAGE LOANS TO ASSIST THE ELDERLY

Several private institutions and government agencies are currently working out diverse ways of allowing elderly homeowners to remain in their homes while receiving cash benefits without selling the home. Some of these techniques available or under study include the reverse annuity mortgage and senior citizen equity loan plans.

Reverse annuity mortgage

FHLBB authorized the reverse annuity mortgage on December 14, 1978. Its objective is to help senior citizens enjoy their accumulated home equity without having to sell their homes and differs substantially from the other mortgage instruments discussed in this report.

The rationale behind the reverse mortgage program becomes clear when we look at housing patterns among the elderly. The elderly represent 11 percent of the American population and constitute 20 percent of all households and 21 percent of all homeowners. In 1976, 82 percent of all household heads aged 65 or over owned their own homes.

Ironically, elderly homeowners are concentrated in the lowest income classes. Well over one-half of all homeowners with incomes under $5,000 are elderly households. Single elderly people comprise the largest segment in the lowest income category. Six out of 10 single elderly homeowners have incomes below $5,000. Thus, the people with the highest percentage of debt-free homeownership are also the people with the lowest income.

These elderly homeowners are sometimes forced to sell their homes to raise the necessary money for living expenses. This is unfortunate since a major source of security for the elderly is to be in familiar surroundings.

A reverse mortgage is structured like a life insurance annuity plan. It is a "reverse mortgage" because the monthly payments flow from the lender to the borrower. This type of mortgage financing permits a borrower to receive from a lender a specified amount of money for a stipulated time period based on the real property's unencumbered value. Interest would accrue, but would not need to be paid until loan maturity. This is somewhat comparable to a construction loan, which starts with a zero balance and builds to a specified amount when it matures.

Presently, only one savings institution--in Independence, Ohio--is involved in issuing reverse mortgages. The mortgage loan liaison officer at the association told us that their RAM program had only recently been started and no major problems had surfaced during the early implementation phase.

Senior citizen equity loans

Presently, several types of loan plans geared to elderly homeowners are being studied by private and public institutions. In one effort, the San Francisco Development Fund is conducting a 2-year demonstration project, funded by the San Francisco Foundation, the FHLBB, and the Ford Foundation. The project will involve in-depth study directed toward developing a number of workable loan options which will then be made available to eligible senior citizens after testing and analysis.

The San Francisco Development Fund is also coordinating its efforts with a project being conducted by the State of Wisconsin's Bureau of Aging. This project is funded by the Department of Health and Human Services. The Wisconsin study will assist four pilot projects besides San Francisco--one in Buffalo, New York, and three in Wisconsin: Madison, Milwaukee, and Monona. Two options are now being analyzed--a straight reverse mortgage loan and the sale and leaseback concept. Other possible options involve a loan from a bank or savings and loan combined with an annuity from a life insurance company for either a fixed term or the lifetime of the annuitant.

Although the senior equity plans are not finalized, the plans now being studied provide for a senior citizen to sell his or her home to a private buyer and enter into a leaseback agreement with the buyer. The leaseback is structured as a

guarantee of the senior citizen's right to continued occupancy for as long as desired.

The buyer assumes responsibility for the real estate property taxes, fire and liability insurance, major maintenance, and also executes a promissory note to the senior citizen which is paid off over a 10- to 15-year period. When the amortized payments have paid off the note in full, the buyer purchases a single-premium, nondeath benefit annuity that guarantees continuance of the same monthly payments to the senior citizens. The annuity generally provides a fixed income to the senior citizen for life, while the buyer purchases the house at a discount and benefits from any rise in property values that may occur.

TWO STATES' EFFORTS TO PROMOTE ADJUSTABLE RATE MORTGAGES

We visited two States--Wisconsin and California--where our research showed mortgagees actively issuing adjustable rate mortgages. In Wisconsin, State-chartered financial institutions have been issuing escalator clause mortgages for many years. State officials estimate that 90 percent of Wisconsin's mortgages made in 1979 were the escalator clause type. In California, some State-chartered savings and loan associations have been actively issuing variable rate mortgages since 1975. As of December 31, 1979, the loan portfolio of the 30 institutions offering VRM's included 269,299 VRM loans worth $19 billion.

Characteristics of the Wisconsin escalator clause mortgage program

State-chartered thrift associations in Wisconsin have had the authority to issue escalator mortgages since at least the 1940s. Current regulations state that no interest rate increase may occur until 3 years after the mortgage contract date, and the borrower must be given at least 4 months written notice of the lender's intent to increase the interest rate. During the 4-month period, the borrower may repay the loan without penalty. The lender is allowed to increase the interest rate 1 percent initially and 0.5 percent each year thereafter. Any time the interest rate exceeds the original rate by more than 2 percent, the loan may be paid without penalty.

The interest rate adjustment notice shall include the effective date of the increase, the new interest rate and how much it exceeds the old one, and the borrower's new monthly principal and interest payment. Also the borrower shall be informed of his or her right to increase principal and interest payments, to repay within 4 months without charge if there is an interest rate increase, and whether as a result of the increase, a lump sum payment may be necessary at the end of the loan term.

Current Wisconsin escalator mortgage regulations became effective in 1976. Before that time the borrowers signing for this type of mortgage agreed to permit their lender to increase the interest rate with no limitations, at the lender's option. The only restriction was that the lender could not increase the interest rate for the first 3 years of the mortgage, and then only upon 4 months written notice. The borrower had the option to prepay the loan without penalty within the 4-month period.

The open-ended aspect of Wisconsin escalator mortgage was not a concern until 1974. At that time, money market fluctuations resulted in a major disparity in thrift associations' income and cost of money, and many lenders exercised their options under the clause. This resulted in the current regulations limiting interest rate adjustments.

Responding to the current rise in inflation and interest rates, some lenders in Wisconsin are considering using rollover mortgages with no guarantee to renew. Without the guarantee, lenders do not have to comply with the interest rate limitations placed on the escalator mortgage. When the note is rolled over, the new interest rate is set at the lender's discretion, thereby maintaining the lender's maximum flexibility.

Characteristics of the California VRM program

In June 1971, California State-chartered thrift institutions were allowed to make mortgages with interest rates that vary with the cost of their deposit funds. The authority was granted in response to the rapid rise in interest rates occurring in the late 1960s. Thrift institutions were locked into fixed rate loans of long maturity and relatively short-term deposits whose rates reacted more quickly t inflationary pressures.

California's VRM regulations allow VRM's to increase 1/4 percent semiannually, with a maximum increase of 2-1/2 percent over the mortgage term. Interest rate adjustments are based on movements of the costs-of-funds index for California savings and loans, as calculated by the San Francisco FHLBB. Prior to January 1, 1976, California VRM's were tied to the weighted average cost-of-funds index for FHLBB's Eleventh District (Arizona, California, and Nevada) associations. Interest rate increases are optional and decreases are mandatory, with no downward limitation.

When a VRM is issued, the lender shall disclose to the borrower that the interest rate is subject to change, the standard to which a change is tied, and any limitation to an increase. The borrower shall also be informed of his or her options if an interest rate increase occurs. These options include an increase in monthly payments, an increase in the number of monthly payments or a combination of the two. The borrower shall also be informed of what impact a 1/4-percent interest rate increase would have on a hypothetical loan. All of this information shall be made available to prospective borrowers in a pamphlet provided by the lender.

If a lender chooses to change an interest rate, it shall notify the borrower at least 30 days prior to the effective date of the changes. At the borrower's option, the monthly payment may change, the maturity date may be extended or reduced, or a combination of the two. If the change increases the interest rate, the lender must inform the borrower of his or her right to prepay all or part of the loan within 90 days.

CREATIVE FINANCING TECHNIQUES

High interest rates, combined with a shortage of lendable funds, have encouraged buyers, sellers, and real estate agents to look for nonconventional, or "creative," ways of mortgage financing. These methods usually involve some combination of buyer assumptions of the present home mortgage plus seller acceptance of part of the loan. Some of the consumer financing devices being used are discussed below.

Assumption

The home buyer takes over the existing mortgage at the old interest rate and gives the seller a downpayment equal to the seller's equity in the property. Veterans Administration and FHA loans are normally assumable and have no escalation of interest. In addition, some States require State-chartered banks and savings and loan associations to permit such assumptions without raising the interest rates.

Some conventional loans are not assumable, however, and some may float to the current interest rate. Additionally, if the seller has a large amount of equity in the property, the buyer may not be able to afford the downpayment. In such cases, the seller may finance the buyer's downpayment, which could have tax advantages for the seller and give the buyer the advantage of a lower interest rate.

Seller-backed deed of trust

If a seller owns his or her home outright, he or she may grant a first mortgage loan to the buyer, usually below the market rate. The seller may then resell such a loan in the secondary mortgage market (after checking to be sure they are not violating usury laws) if cash is needed immediately.

Second deed of trust

This device combines the first two. The buyer makes a downpayment to the seller and assumes the first mortgage. Then the seller carries back a second deed of trust for the balance of the payment at a lower-than-bank interest rate.

Wrap-around

The wrap around simply packages old and new financing together. The buyer makes a downpayment and gives the seller an all-inclusive deed of trust at a below-bank interest cost for the remainder of the selling price. The seller agrees to continue paying the old mortgage and keeps the remainder of the monthly payments.

Wrap arounds are legally precarious if the first mortgage is held by a federally chartered institution or if mortgage assumptions are not allowed in a particular jurisdiction. On

transfer of title, the mortgage lender may exercise a due-on-sale clause calling for repayment of the entire loan or may raise the interest rate to market levels. Experts advise that parties check both the terms of the original mortgage and relevant State laws before attempting these.

Lease-purchase option

The buyer leases the property with a delayed sales closing date. The buyer usually pays a deposit which is commonly applied to the downpayment, and part of the monthly rents may be similarly applied. The buyer benefits by locking in the purchase price of the property at the time he or she signs the lease purchase agreement. The seller receives option money immediately as well as the lease payments while retaining the tax benefits of ownership until the option is exercised.

Land lease

Long used in Hawaii, this practice is now spreading to other States. Buyers purchase only the house and other improvements while leasing the land for 99 years. This tactic can reduce a downpayment as much as 25 percent and also trim monthly payments. Monthly lease payments may eventually be applied toward land purchase.

Equity sharing

This is a type of joint venture between a resident owner and an investment owner. The two partners share downpayment and monthly payment costs as well as any increase in equity that the house may experience. Equity sharing usually is set up to allow the resident-owner to buy out the third-party investor.

APPENDIX III

Federal Home Loan Bank Board

JOHN H. DALTON
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

February 27, 1981

Mr. William J. Anderson
Director, General Government Division
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Anderson:

The Federal Home Loan Bank Board (the Board) appreciates the opportunity to comment on the draft report of the General Accounting Office (GAO) entitled "Federal Mortgage Credit Regulators Need to Develop Uniform and More Comprehensive Consumer Safeguards for Alternative Mortgage Instruments" (the draft report). The draft report treats two separate topics: (1) consumer safeguards and the provisions of adjustable-rate-mortgage instruments; and, (2) FHA Section 245 graduated-payment mortgages administered by the Department of Housing and Urban Development. Inasmuch as the latter topic pertains primarily to another agency of the government, the Board will comment only on the former topic.

It is important to note that an urgent necessity exists for thrift institutions to have the power to originate adjustable rate mortgages with an adequate degree of rate flexibility if they are to survive in an inflationary environment, an environment characterized by volatile interest rates. The Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221) mandated a complete phaseout of interest rate ceilings on savings and time accounts within a six year period. The deregulation of these liabilities is occurring at a much more rapid pace than anticipated. Already, almost all new funds being obtained by thrift institutions are at market rates rather than at the old fixed-rate ceilings which are substantially below current market rates. As of January 31, 1981 our figures indicate that at least 56% of the savings deposits of FSLIC-insured institutions were liabilities with market-related rates of return representing an increase of approximately 20% over the previous year's figures. Specifically, 37% was deposited in the six-month money market certificate, 10.7% was deposited in the 2 1/2-year "small saver certificate" and approximately 8% was deposited in jumbo certificates of deposits (short-term deposits of over $100,000).

Poor earnings, and in many cases losses, are resulting from the difference between the high and volatile cost of such market-related savings and the low yields on fixed-rate, fixed-term mortgage portfolios. Thus, it is clearly evident that the nation's primary mortgage lenders are unable to exist in this environment by borrowing short and lending long, while at the same time paying savers

market rates on savings deposits -- rates to which savers are justifiably entitled. It is, therefore, imperative that thrift institutions be afforded the necessary ability to originate an adequate volume of adjustable rate mortgages in order to assure the availability of mortgage financing.

Although the draft report accepts the concept of a variety of alternatives to the standard fixed-rate, level-payment, fixed-term mortgage, it does express concern with the need to develop uniform consumer (borrower) safeguards. The safeguards discussed are: (1) that borrowers should be provided a choice between a fixed-rate mortgage and the alternative mortgage being offered; (2) that borrowers be given more complete disclosure than is now required under the Board's RRM regulation, i.e., worst-case payment schedules; (3) that borrowers should be given a wider choice of adjustment frequencies and that at each adjustment the borrower be allowed to select the length of the next adjustment period; and (4) that interest rate caps be established which are standardized and which provide mutual protections to borrowers and lenders.

The issue of such safeguards is controversial and must be given considerable attention. In our opinion, what the draft report does not recognize, however, is the complexity of interactions between consumer safeguards and the lender's ultimate ability to make mortgage financing available through the use of adjustable rate mortgage authority.

The Board has long supported the adoption of adjustable rate mortgage authority for federal savings and loans because the high and variable rates of inflation the nation has experienced over the last fifteen years have resulted in high and volatile interest rates which make the standard mortgage instrument unacceptable to both the borrower and the lender. Nevertheless, the vast majority of S&L assets are currently in the form of fixed-rate mortgages with maturities significantly longer and yields significantly lower, than those of the liabilities that support these mortgages. As a consequence, operating losses have become common for a significant segment of the industry. One of the more promising ways to ameliorate this condition is to provide <u>usable</u> adjustable rate mortgages.

In order for adjustable rate mortgages to be usable, the needs of the borrower and the lender must be delicately balanced. The borrower needs to have an adequate supply of affordable mortgage credit available in the marketplace to meet demand. (The demographics for the decade of the 1980's demonstrate an unprecedented demand for mortgage credit.) Moreover, the borrower needs to know, in simple and concise terms, what the obligation of the borrower is under the mortgage selected. This latter point is true irrespective of the type of mortgage involved -- a fixed-rate or some alternative form of mortgage.

Likewise, lenders need sufficient earnings to carry the cost of liabilities -- liabilities which fund mortgages. Additionally, lenders need the flexibility to originate mortgages which will foster development of a viable secondary market. Although adjustable-rate

mortgage loans are more attractive to lenders to hold in portfolio in times of rising interest rates than are fixed-rate loans, the adjustable-rate concept does not eliminate the needs of primary market lenders for immediate additional capital to make additional mortgage loans. The development of a secondary market in these loans will be crucial to the success of the adjustable-rate-mortgage concept as well as the industry's ability to make mortgage credit available.

Thus, the extent to which each party is afforded certain safeguards should be viewed with the foregoing respective needs in mind.

Recent experience has indicated that when lenders are required simultaneously to offer fixed-rate loans and make worst-case disclosures, they have been unable to originate a significant amount of adjustable-rate mortgages. The Federal Home Loan Bank Board believes that the marketplace works, and that if there is demand for a fixed-rate mortgage instrument, borrowers will be able to find one. Inevitably, such requirements make it difficult for the lender to originate adjustable-rate mortgages without offering lower than market rates of interest on the adjustable-rate mortgage or liberalizing terms to such an extent that the lender is provided no assurance that it can operate profitably and support its liabilities.

The assertion made in the draft report that a lender should be required to offer a standard mortgage instrument in conjunction with an alternative mortgage instrument because the lender can reduce interest rate risk in other ways, i.e., loan sales to other investors, is only partially true. Secondary-market purchasers of mortgages have a limited capacity to buy such mortgages, particularly during tight credit periods.

Similarly, the requirement that disclosure materials provide a worst-case comparison has already proven to be a very serious deterrent to the ability of lenders to offer adjustable-rate mortgages. Current Board regulations require such a worst-case disclosure for variable rate mortgages (VRMs). This disclosure feature has been the principal reason why few S&Ls have been able to offer VRMs. We note that the draft report acknowledges that a worst-case disclosure requirement has been at least partially responsible for the limited use of VRMs by federal S&Ls.

Likewise, the draft report recommendation that borrowers be given a choice at the time of each interest rate adjustment in the length of the new adjustment period would create several problems. The recommendation presumably contemplates that the borrower would be given a choice among a greater number of options at the time the loan is originated, but the length of the successive adjustment periods would be unknown at the time of the origination of the loan. Allowing the borrowers such a choice would create uncertainty for the lender in portfolio management and determining a fair interest rate at the time of origination. Further, a choice in the length of successive adjust-

ment periods would create a serious impediment to the development of a secondary market in adjustable rate mortgage loans. The ability to group together loans of uniform characteristics is crucial because the secondary market in mortgage-backed securities must have the ability to account for loans on a group basis. While all of loans of a mortgage-backed security need not be identical, secondary market investors usually require the interest rates on the loans to be subject to change at the same time and by the same amount.

Thus, this proposal of the draft report would create two problems for the Federal Home Loan Mortgage Corporation (Corporation). First, the Corporation will not be able to pool sufficient volumes of loans together to be able to sell them in the form of mortgage securities in order to finance future purchases. In order to obtain this volume of similar loans, the Corporation will likely select one length of adjustment period for loans to be sold to the Corporation. If the choice of the length of the adjustment period were the borrower's, the Corporation would not be able to achieve this necessary standardization. Second, even if the Corporation were able to purchase a sufficient number of loans with adjustment periods that were initially consistent, the ability of the borrower subsequently to alter the length of succeeding adjustment periods would destroy the uniformity of pools which had been created. If loans within the various pools could be adjusted on different schedules, and therefore by different amounts, the Corporation would not only be required to convert to individual loan accounting; it would also be issuing securities on which the return would change on such a random basis that it is not likely that the securities would be attractive to investors.

The draft report appears to be based upon a misunderstanding of the nature of the adjustable rate/renegotiable-rate mortgage loans. The RRM is interpreted in the draft report to be a series of short-term loans secured by a long-term loan on which the rate may change at predetermined intervals. The reference to consumer choice of "note maturities" reflects this view of the RRM (as compared with the VRM) as a series of short-term loans. Viewing the RRM as a series of loans, with each adjustment period representing a new loan, erroneously leads to the conclusion that there is no reason for requiring that the terms be set at the beginning of the 30-year period and to require each successive "new loan" to be identical to the preceding one. The draft report, therefore, makes reference to the Canadian rollover, under which the borrower chooses the length of each loan term at the beginning of that term, emphasizing the fact that in Canada the borrower has a real choice.

This comparison with the Canadian rollover is inappropriate and somewhat misleading, as that instrument truly contemplates a series of balloon loans. While it may be true that the borrower has some choice

as to the length of subsequent loan terms and that all loan terms need not be identical, the matter is open to negotiation with the lenders, as the lender is under no obligation to renew the loan. Further, we understand that there are no "caps" to restrict the Canadian lender's ability to raise interest rates. Thus, the lender simply determines whether or not to make a new loan and the terms of any such new loan. In such a case, the borrower can accept the new terms or seek a better deal elsewhere, i.e., the only protections to the borrower are the protections resulting from competition in the marketplace. A comparison of the Canadian instrument with the RRM on the issue on which the GAO is focusing is, therefore, an unfair comparison of dissimilar instruments. A major protection is offered to the consumer under the Board regulation which is not offered in Canada: The certainty on the part of the borrower that his/her loan will remain in force for up to 40 years, unless he or she chooses to repay it sooner.

The final issue raised in the draft report relates to appropriate interest-rate-adjustment limitations, or "caps." There are essentially two points which the draft report makes in this regard. First, the report emphasizes the need for standardization among applicable regulations. Second, the need for caps which protect the needs of the consumer is discussed.

With respect to the appropriate limitations on interim and overall rate adjustments, we wish to stress the necessity of balancing two competing objectives. On the one hand, if the instrument is to be sufficiently attractive to lenders and investors to be workable, the possibility of raising interest rates to a reasonable degree in the event that market rates increase is necessary. If the lender is too restricted in its ability to adjust rates, the lender will be taking on substantial administrative burdens and the uncertainties of a new instrument without obtaining in return the ability to adjust interest rates in a meaningful way. Severe limitations on the ability of the lender to raise rates, particularly when coupled with unrestricted rate decreases, would likely make the instrument unworkable.

On the other hand, giving the lender an unlimited ability to raise interest rates could create severe problems for both borrowers and lenders. The possibility of unlimited rate increases might make underwriting of these loans much more difficult. Default risk could increase, and a high rate of default would be as detrimental to lenders and investors as it would be to borrowers.

The draft report goes beyond a consideration of the appropriate rate-adjustment limitation (up and down), however, and implies fairly strongly that there should be no downside cap. This recommendation appears to be based, at least in part, upon a misunderstanding of the requirement that the borrower be permitted to prepay without penalty at any time after the first rate-adjustment notice is given. The example given on page 39 of the draft report, in which the lender is

originating new mortgage loans at 12 percent while renewing RRMs at a rate of 15.5 percent, appears unrealistic. While there are some costs to the borrower in connection with refinancing a loan, making it unlikely that a borrower would refinance to take advantage of an interest rate differential of a few basis points, the view that the borrower would be locked into a loan at a rate three-and-one half percentage points above market is unrealistic.

As noted earlier, the viability of savings and loan institutions has been severely hurt by the precipitous deregulation of interest rates on savings. In short, the cost of liabilities to the savings and loans has undergone tremendous structural alterations and they are now priced to yield the saver current established market rates of interest. Nevertheless, asset deregulation in terms of being able to offer mortgage instruments not subject to rigid limitations has not been accomplished. Adjustable rate mortgage instruments exist in an embryonic stage of development. Even with the advent of more flexible and usable mortgage instrument assets which respond to market conditions in the same fashion as liabilities, it will take many years before these institutions can adjust a sufficient proportion of their mortgage loan portfolios in order to provide the kind of earnings ability needed to survive as mortgage lenders and thrift depositories. It therefore becomes all the more urgent that savings and loans be given maximum flexibility with respect to originating adjustable-rate mortgage loans without unreasonable constraints that will act as a deterrent to providing affordable mortgage credit to our nation.

Sincerely,

John H. Dalton

JHD/sls

APPENDIX IV

Comptroller of the Currency
Administrator of National Banks

Washington, D. C. 20219

February 13, 1981

Mr. William J. Anderson
Director
General Government Division
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Anderson:

This is in response to your request for comments on a proposed GAO report entitled, "Federal Mortgage Credit Regulators Need to Develop Uniform and More Comprehensive Consumer Safeguards for Alternative Mortgage Instruments." In the draft report, GAO recommends that the Federal Home Loan Bank Board (FHLBB) and the Office of the Comptroller of the Currency (OCC) cooperate in the development of uniform and consistent consumer safeguards for existing adjustable-rate mortgage instruments and those in the planning stage. Among the specific recommendations of GAO are that borrowers be given the right to choose between a fixed-rate and an adjustable-rate mortgage loan; that borrowers be given parallel disclosures which allow comparison of payments due under fixed-rate and adjustable-rate instruments, assuming maximum possible rate increases; and that borrowers be offered adjustable-rate loans with standardized interest rate caps which fairly protect the interests of borrowers and lenders.

In September, 1980, the OCC proposed for comment its regulation on adjustable-rate mortgage (ARM) lending by national banks. In early December, 1980, FHLBB and OCC jointly sponsored hearings on ARM regulations in Washington, DC, Chicago, and Los Angeles. At that time, the OCC extended its comment deadline on the proposed regulation from November 24, 1980, to December 30, 1980. To date, we have received 331 written comments on this matter. We are now in the process of evaluating our proposed regulation to determine if adjustments are necessary in light of the information received in the rulemaking

Our objective is to encourage national banks to help meet the increasing demand for residential mortgages over the next decade, recognizing the need for market-sensitive mortgage instruments. The proposed regulation reflects our desire to provide sufficient latitude to encourage experimentation, while at the same time protecting the rights and interests of borrowers. This is especially important during the early stages of development of these instruments. While uniform rules among the agencies regulating financial institutions are desirable, we do not believe that this goal should be paramount to the banks' need for flexibility to innovate in this area. We are opposed to attempts to freeze development of new instruments, by standardization or otherwise, before they can be tested by the discipline of the marketplace.

Furthermore, because the evaluation of our proposed regulation is now under way, we feel constrained in responding to GAO's draft report at this time. It would be premature for us to express any definitive views until this process is farther along. However, we intend to carefully weigh the issues raised in the draft report as we proceed to finalize the regulation.

If you have questions in the interim, please do not hesitate to contact us.

Very truly yours,

John G. Heimann
Comptroller of the Currency

APPENDIX V

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

March 12, 1981

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING - FEDERAL HOUSING COMMISSIONER

IN REPLY REFER TO

Mr. Henry Eschwege
Director, Community and Economic
Development Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Eschwege:

Your letter of January 16, 1981 transmitting a proposed report to the Congress, entitled "Federal Mortgage Credit Regulators Need to Develop Uniform and More Comprehensive Consumer Safeguards for Alternative Mortgage Instruments," has been referred to us for reply. We shall address the recommendations as presented in the report.

(1) The Secretary of HUD should require HUD underwriters be provided with criteria to assess future income of homebuyers applying for a Section 245(a) graduated payment mortgage.

Reply

While the idea has some merit in theory, we cannot envision a set of criteria which would not discriminate against some class of buyers on the basis of age, profession, etc. Moreover, few employers would be willing to provide the type of assurance that would be necessary as to the future income potential of the borrower.

GAO's concern is directed at early default risk. In identifying equity-to-value as the "strongest predictor" of default, the paper does not compare the relative equity positions of 245 and 203(b) homeowners over time. In this respect, it is important to recognize that 245(a) buyers, under all five program options, make downpayments which substantially exceed the minimum requirement in 203(b). The larger downpayment tends to offset default risk in two ways: (1) to the extent a larger equity investment is made initially, the 245 owner stands to lose more upon foreclosure, and therefore, has a vested interest in retaining the property; and (2) when a default occurs, the 245 buyer's equity investment may be sufficient to permit a recasting of the loan to provide for a lower monthly payment or may facilitate the selling of the property by the borrower to avoid the problems of foreclosure.

2

Actuarial studies indicate that risk is reduced considerably as the cash investment of the borrower exceeds ten percent. In the example cited on page 52, the borrower is required to make a 12 percent minimum investment.

(2) The Secretary should take steps to assure participation of Section 245(a) ten-year graduation plan in the Government National Mortgage Association's mortgage backed securities program.

Reply

At present, only five-year GPM loans are eligible for GNMA pools. It would be exceedingly disruptive to the MBS program to include loans with increases in monthly payments over a ten-year period. The acceptance of only the five-year plan loans was agreed to approximately two years ago in meetings that included securities dealers, representatives of investors, securities issuers, and HUD staff.

The disruption that would be caused by the inclusion of ten-year loans would affect all borrowers whose loans are financed through the GNMA program, not just those who obtain ten-year GPM loans. It is extraordinarily important to those who invest in GNMA securities that there be the maximum possible degree of homogeneity among loans in various pools. This homogeneity makes prepayment experience and other aspects of cash flow predictable to the maximum extent possible. By assuring homogeneity, we induce investors to buy GNMA securities with the lowest possible yield.

Should the investors' confidence in this homogeneity be shattered through an after-the-fact expansion of the program to include ten-year GPM loans, the marketplace would lose confidence in the integrity of the Mortgage-Backed Securities Program. The result would be higher interest rate requirements on all GNMA securities. These higher interest costs would be passed along to all FHA and VA home buyers.

As a result, we do not believe it is appropriate at this time to modify the MBS program.

(3) The Secretary should take steps to assure home buyers are apprised of all payment plans available under the GPM program. One way to do this would be a certification signed by the homebuyer that they were informed of all options available.

Reply

The Department has expended considerable effort to advertise the various plan options of the program. Each of the Department's three brochures on the GPM program include descriptions of the five plans.

3

However, lack of consumer interest and lender and realtor reluctance to get involved with other plan options coupled with the secondary market problems mentioned above have combined to cause the minimal activity under the other four plans. Accordingly, while we can appreciate GAO's intent, this recommendation will not guarantee that more borrowers will avail themselves of the other plan options. Our experience indicates that homebuyers are seeking the plan which offers the lowest initial payments. In addition, if a lender is unwilling to make a particular loan, HUD cannot compel it to do so. Because the use of other plans will add to the administrative costs (development of payment factors, education of staff, etc.), many lenders are reluctant to invest the effort necessary to make the other plan viable. This situation is further exacerbated by the lenders' belief that there is no market for those other plans. Until there is significant evidence that borrowers prefer one of the other plans, we cannot expect any lenders to make the necessary commitment. Accordingly, we do not believe that this recommendation should be adopted.

If we can be of further assistance, please let me know.

Sincerely,

George Hipps

George O. Hipps, Jr.
Acting Deputy Assistant Secretary

(388110)

*U.S. GOVERNMENT PRINTING OFFICE: 1981-0-341-843/718